2010 EUROPEAN HOUSING REVIEW

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INTRODUCTION

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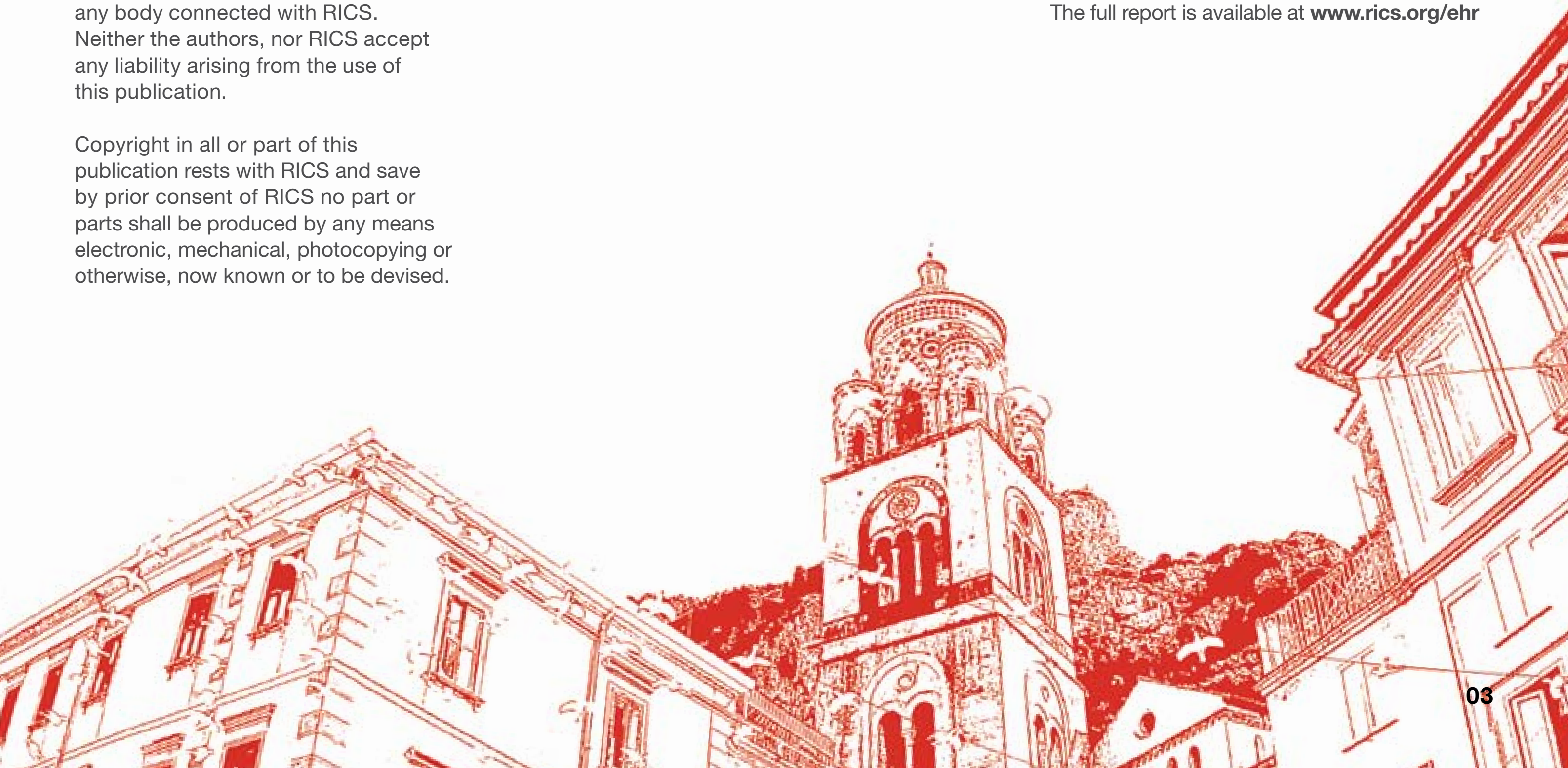
While every effort has been made to ensure that the data and other information in this report are accurate, some errors may remain. In addition, it should be remembered that information in this field is variable in content and quality. The purpose of the Review is to provide information, analysis and background to Europe's housing markets and housing provision systems. It is not intended for use directly either in market forecasting or for investment decision purposes. The full report is available at **www.rics.org/ehr**



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PREFACE

Interest in European housing markets has expanded considerably in recent years. This report provides information on housing in individual countries and comparative housing market analysis across Europe.

This Review aims to:

- Offer coverage of housing and mortgage finance systems
- Examine housing markets in a comparative pan-European way
- Give informed interpretations of data and events
- Create quick reference information on housing and related topics, such as the economy
- Provide an understanding of the current state of housing markets
- Enable evaluation of the growth of homeownership
- Consider the role played by rental housing
- Comment on housing markets in the context of macroeconomic and demographic influences
- Outline important policy change.

The format adopted is to provide introductory comparative chapters, presenting an overview of recent developments. They are followed by specific country reports on a chapter by chapter basis. These reports explain, where possible, the broad structure of a country's housing system, examine macroeconomic, financial, policy and other influences on housing demand and supply and evaluate current market conditions.

Given the large number of countries in Europe, it is not feasible to provide individual chapters on all countries. Instead, after the initial pan-European analysis, 10 countries are examined in detail. The policy is to include all of the four largest economies, plus a variety of others from around the EU.

Emphasis is put on residential markets at the national level. Where of particular significance regional issues are considered, but it is beyond the scope of this study to undertake detailed regional and city analyses.

Housing markets are continually changing and there is a danger that information becomes out of date quickly. This report was completed in the last weeks of 2009 and, so, obviously cannot comment on or describe any events occurring later than that. Headline price data in Chapter 1 were updated early in February 2010.

Secondary sources were predominantly used but many estimates and manipulations of data were undertaken by the author. For simplicity, however, only the sources of independent data used are cited in the Figures and Tables.

This is the twelfth year since the first Review was published. The author should like to express his gratitude for continued support of the Royal Institution of Chartered Surveyors over the years and, in particular, for the helpfulness of RICS Head of Research, Stephen Brown and RICS Chief Economist, Simon Rubinsohn.

CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

Unsteadily coming back from the brink

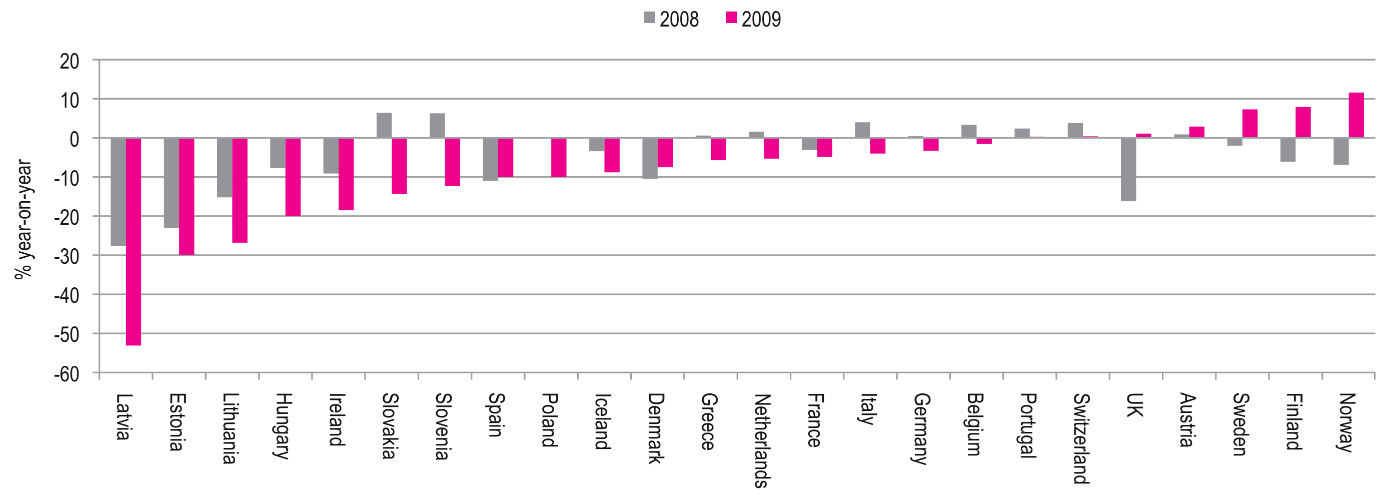

Figure 1.1: House prices in Europe[1]

December or last quarter of year, annualised rates

2009 was a year of two halves for many European housing markets. The first half was full of gloom, as reverberations continued after the world financial crisis following the collapse of Lehman Brothers in the autumn of 2008. Mortgage markets were still tightening - to the point of strangulation in some countries; economies were plunging into deeper recession; unemployment was rising; housebuilding collapsing; and consumer and investor expectations could not have been much worse. In such circumstances the house price falls already witnessed in 2008 could only intensify, which they did apart from a few exceptions (namely Austria, Norway and Switzerland).

By contrast, the second half of 2009 saw housing markets in many countries bottoming out and showing signs of recovery. Somewhat paradoxically, the initial signs of recovery were often first observed in sales prices, rather than in transactions levels, mortgage finance or housebuilding. This was because in several places demand revived faster than available supply. In them, existing owners had little incentive to sell if they expected prices to firm up more in the near future and housebuilders had little to offer in the way of supply either, because they had cut back building and had little unsold stock left.

In some localities, price recovery has been substantial. Norway, Sweden and the UK all saw house prices in 2009 bounce back by over 8% from their troughs in less than a year (11% in Norway's case). Such recorded house price inflation rates would not have been out of place in the so-called 'reckless-easy-credit-bubble' days of the near past.

If the prevailing evidence is right, the European housing crash seems to have been relatively short-lived - though several countries' housing markets are still in deep trouble. If the same trend continues, as it is likely to, the European housing downturn of 2008/9 will have turned out to be far smaller and more localised than most would have expected in late 2008, and vastly short of the forecasts of the doomsayers featured so often in web commentary and the traditional media.

Markets are by no means back to normal. The scale of the shocks in both 2007 and 2008 will take some time yet to work their way through. There will also be some permanent changes that have resulted from them, especially in the triangular relationship between housing markets, finance and public policy.

The world is also a more uncertain place, so further shocks may destabilise housing markets again soon. Even if that does not happen, it is highly probable that the housing market cycle will be a lot shorter in the future than it has been over the past twenty years.

[1]*House price data are of variable quality, coverage and timeliness. Reported here are all housing price indices or, if not available, single-family ones; except for the Baltic States where capital city apartment indices are used. Sources: National Statistics Offices; Central Banks; Housing Ministries. Plus: NyKredit, Denmark (2008); FNAIM, France; Hypoport, Germany; ESRI-Permanenttsb, Ireland; Scenari Immobiliari, Italy; FHB, Otthon Centrum, Hungary; BPE, Estonia; Ober-Haus, Lithuania; ARCO, Latvia; REAS, Poland; Confidencial Imobiliário, Portugal; Wüest, Switzerland; Lloyds-Halifax, UK*

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The uniqueness of Europe's experience

One of perhaps the least surprising features of the past two years has been that world housing markets have been affected by the economic and financial crisis in different ways. This geography is true for both the major regions of the world and for distinct places within countries themselves. For instance, most of Asia-Pacific has seen little or no housing market turmoil, in contrast to America and Europe. There have even been price booms in parts of China and India. Similarly, turning to within-country developments, a good instance of differentiation is the US housing market. It has been a divergent one of disaster-struck coasts and generally tranquil mountains and plains. Other examples abound.

Consequently, a simple maxim is required when examining Europe's housing experience of recent years. There are both common experiences and some widely divergent ones.

General performance across Europe residential markets

Regarding the past year in Europe, a number of key housing market factors are apparent:

- After relatively modest price falls in the main, there are signs of fragile recoveries, especially in sales levels and prices
- New mortgage business has fallen everywhere, but to widely varying degrees, and recovery will be equally mixed
- House sales are way down on earlier boom levels, again by varying amounts, and market turnover is unlikely to recover to earlier levels when 'normality' returns
- Housebuilding is down sharply to various degrees
- Supply gluts are only localised and country-specific but where they exist they are continuing to drive prices down
- Recovery in housebuilding faces enormous difficulties, because of continuing dysfunctionality in development finance and land markets
- The housing market cycles differ in their timing across Europe and the dissimilarities are influenced by country-specific housing market, economic, policy and demographic factors
- The worst performing markets lie in a horseshoe shape around the edge of Europe, though not in the north because recovery in Scandinavia has generally been amongst the strongest.

The unlucky horseshoe

There are a series of countries where housing market performance is particularly fraught. Geographically, they are linked in a horseshoe shape in the west, south and east surrounding the rest of Europe. The horseshoe shape starts in Ireland; passes southwards through Spain; turning eastwards through the Mediterranean islands and Greece; then northwards into much of central and eastern Europe (CEE); before ending in the Baltic States.

Again, although there are specific stories to be told with regard to each of these countries, it is true to say of all of them that their housing market problems are especially difficult because they have a mixture of poorly performing economies, weak public finances and declining housing markets that feed problems into each other. House prices and associated debt rose fast in the boom years. Up to the crash, housebuilding grew rapidly as well - in the CEE countries from low bases. As a result, there are now typically large oversupplies of recently built dwellings waiting to be sold. Wind-downs of building have been drawn out, dragging out the pain, and further depressing their economies and worsening public budgets.

Housing markets in the unlucky horseshoe are likely to take longer to recover than elsewhere in Europe. Even then, the speed of change will vary. Arguably, the north eastern tip in the Baltic States will take the longest to recover.

The varied experience of core European housing markets

The positive influences on incipient recovery in the core housing markets of Europe during 2009 related to government and central bank policy; to fairly rapid, if timid, recovery in economies, which in continental Europe were mainly coming out of recession by autumn 2009; to the reaction of households and other market players; and to the dynamics of earlier housing market cycles.

The picture of the boom years up to 2007 is one of considerable variation across Europe. Germany, Austria, Portugal and Switzerland, for instance, did not even have pre-crash housing booms. (This did not protect them entirely from the crash, though of the four Germany probably fared the worst, but still better than many of its neighbours).

Nonetheless, there remained a greater than usual co-ordination in cycles across quite a large number of countries. Along with that experience came common ones of considerable real price rises and much extra mortgage debt. Some boom influences were global in reach. They included a general easing in credit; declining inflation for much of the period; and falling real interest rates, driven by imbalances in world savings and expenditure between Asia and the West. Others were more country, or even city, specific. They related to general macroeconomic performance but also to a multitude of micro-economic issues often neglected in cross-country housing market commentaries, such as demographics and migration; taxation; housing policy; a variety of institutional features; and local supply-side factors.

Unsurprisingly, a similar mix of global, European level and local influences is driving current downswings and recoveries. What is more, European governments and central banks have responded in different ways to the economic and financial crisis; utilising distinct policy instruments with varying effects on housing markets, with a mix of mistakes and successes.

Reacting to the shock of the financial crisis

European banks were some of the worst hit by the credit crunch. They invested heavily in what are now known to be near worthless 'toxic' assets. They were active in, since frozen, asset-backed security and derivative markets and faced sudden liquidity calls, which could not always be met. As is well known, European governments were forced to make widespread capital injections into the financial system and several lenders collapsed or had to be rescued. Looking at Europe as a whole, the UK and Ireland had the greatest number of problem institutions, but few countries emerged unscathed.

Deleveraging led to widespread withdrawals from mortgage lending by erstwhile lenders and sharp curtailments by others. Fears of falling house prices and rising defaults added to the problem. A downward spiral of declining lending, tightening loan-to-value ratios (LTVs), falling house prices, negative equity and mortgage default seemed inevitable. After the collapse of Lehman Brothers, fears were high throughout the last quarter of 2008 and into 2009 that the spiral in European housing markets would become self-reinforcing, as it had become in parts of the USA.

No central bank was quick off the mark at the onset of the crisis. The prevalent view at the time of the need to prick house price 'bubbles' no doubt helped to delay reaction. Bank rescues inevitably focused on the financial system and general economic impacts rather than any dealing with potential collateral damage to areas like housing. In fact, however, sharp cuts in interest rates and recent injections of liquidity have worked to aid housing markets.

Mortgage lending has fallen sharply across Europe. The general picture of decline can be seen in Figure 1.2. Previous strong rates of growth evaporated and had turned negative in some countries, such as the UK, in 2008 and even in the euro zone as a whole by 2009 (i.e. more mortgage debt was being repaid back than issued). The decline was partly supply-driven through tightened lending criteria but was also demand-related because households and investors were unwilling to purchase in falling markets and less able to do so due to worsening economic circumstances.

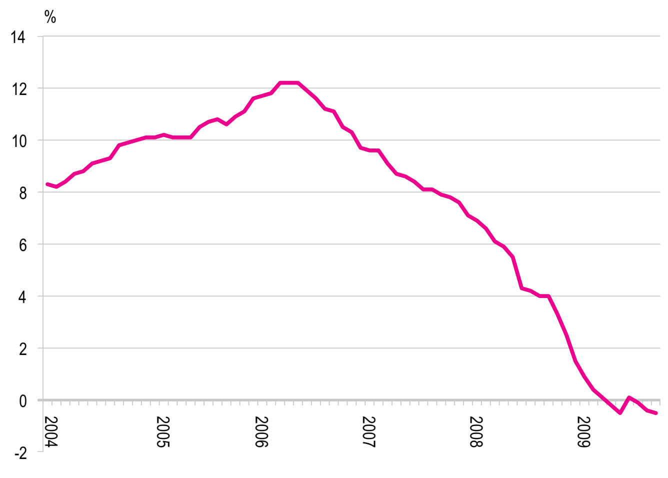

Figure 1.2: Euro zone housing loan growth rate, Jan 2004–Sep 2009

Source: ECB

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The decline in mortgage lending has varied considerably across the EU, according to the ECB, with the greatest falls in Belgium, Ireland and the UK, and relatively moderate falls elsewhere or even continuing strong rises in some places like Slovenia and Slovakia, new entrants to the euro zone (as house prices have been falling in them, this suggests re-mortgaging may have been important).

There have been substantial attempts by the ECB and other central banks to stimulate lending by bank asset purchase schemes and 'quantitative easing'. They have further helped mortgage markets and, hence, housing demand, although the precise impact is hard to measure.

One of the most important and successful programmes was the surprise announcement by the ECB to buy €60bn of euro covered bonds in May 2009. This revived lethargic covered bond markets across Europe, including those outside the euro zone and greatly narrowed spreads[2]. This had the dual effect of encouraging lower fixed-interest mortgage rates and improving the availability of mortgages.

This covered bond purchase programme was in addition to the ECB's existing purchases of mortgage paper as part of its programme of continuing support for the euro zone financial system. Those ECB programmes had already enabled euro zone countries reliant on residential mortgage-backed securities (RMBS) to continue to issue them, although the private market for them was in effect closed. This is likely to have helped to stave off house price collapse in the Netherlands and to have moderated market movements in Spain, because both countries are major users of RMBS. The Bank of England also belatedly started buying mortgage debt from autumn 2008, which has since helped to improve mortgage availability in the UK.

Associated with changes in liquidity in mortgage markets had been a marked cycle in mortgage interest rates. They rose between 2005 and 2008 as European central banks fought inflationary pressures - and continued to do so after the advent of the world financial crisis in 2007. Interest rates then peaked during the liquidity crisis following the collapse of Lehman Brothers in 2008 (Figure 1.3). Rising interest rates had already helped to slow many European housing markets prior to the world financial crash and they continued to do so as the crisis intensified.

Variable interest rate loan costs were the most volatile. They shifted from just over 3% at the end of 2005 to close to 6% in late 2008. This badly affected countries with traditions of predominantly using variable rate loans, such as Ireland and Spain, which have suffered some of the worst house price falls. In addition, borrowers in other countries with traditions of using fixed rates had often switched to variable rate ones when the spreads were attractive, as for example in Belgium, and those borrowers then suffered the full impact of subsequent interest rate rises (especially as it became increasingly difficult to remortgage).

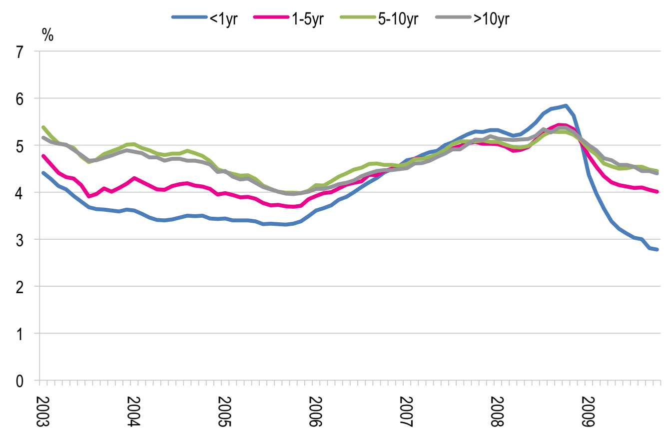

Figure 1.3: Interest on new housing loans in the euro zone, Jan 2003–Oct 2009

Source: ECB

[2] *European Covered Bond Fact Book 2009, ECBC*

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Since the end of 2008, interest rates have moderated as central banks responded to the financial crisis with sharp cuts in interest rates and also because panic subsided in the money and capital markets. A great stimulus to Europe's housing markets in 2009 came through sharp reductions in nominal interest rates. For example, average rates of interest charged on variable rate mortgages in the euro zone fell from a peak of 5.84% in October 2008 to 2.78% in October 2009, according to the ECB. Such rates are historically record lows and fixed rates have also significantly fallen as well (Figure 1.3).

Greatly improved mortgage market liquidity has meant that far more borrowers could access these attractive borrowing costs. Competitive situations amongst lenders and their assessments of house price risks have affected how far mortgage borrowers in specific countries have actually benefited from falling interest rates. Some places like the UK still faced severe, if improving, credit constraints. There is a continuing shortage of liquidity and limited competition between lenders after the collapse or withdrawal of many previous lenders of mortgages to Britons.

The benefit of falling interest rates has affected the circumstances of existing borrowers as well as home buyers. Such beneficiaries have been spread widely throughout the stock of housing, because they include owners and investors on variable rates, those remortgaging, and others coming to the times when their fixed rates are reset (most European fixed rate mortgages have reset dates of five years or less). Some of the largest beneficiaries have been those on tracker rates fixed at low margins before the crisis. For some existing borrowers in places, such as the UK and Ireland, mortgage interest rates have fallen below 1%. Those using long-term fixed interest mortgages have had the further inducement of being able to lock-in good rates for long periods to come.

These interest rate developments have also helped to keep mortgage defaults lower than might have been expected. This low level of default rates has been helped by relatively short-lived recessions, low rises in unemployment compared to previous economic downswings (helped in Germany by government job subsidies), and by rapidly introduced mortgage default rescue programmes. That loan delinquency rates remain low in comparison to previous downturns - if still rising from record low levels at the end of the boom - can be seen by looking at two countries that have experienced some of the most substantial house price falls, Ireland and the UK. Only 2% of mortgages were 3 months in arrears in the UK at probably the worst stage of the cycle in the second quarter of 2009, according to the Council of Mortgage Lenders, and actual repossessions in Britain have been small. Forbearance programmes, agreed between banks and government as part of rescue packages and their aftermath, have helped.

In Ireland, which has had one of the biggest joint housing market and economy crashes, only 30 repossessions occurred in the whole country in the second quarter of 2009, according to the Irish Banking Federation.

Low defaults have meant that there have been few cases of forced sales by existing homeowners in Europe. This is in marked contrast to the early 1990s housing market downturn, when foreclosures helped to push down house prices and prolong depressed market conditions.

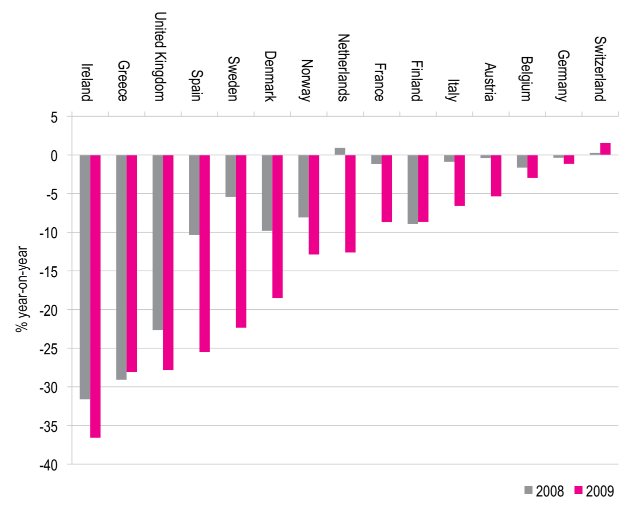

Figure 1.4: Percentage changes in residential investment, 2008 and 2009

Source: ECB

Housebuilding

A mixed picture exists for housebuilding as well. When housing markets turn down, housing supply tends to drop fast. This has been the case in many of the markets that have seen the biggest price falls (Figure 1.4). Yet some countries that have experienced only relatively minor downward price adjustments and had only limited housing supply increases during the earlier boom have seen quite large falls in output as, for instance, in Sweden; whereas others where prices have fallen more, like France and Belgium, have not.

Though a wide variety of factors are likely to have played an explanatory role, to an extent these responses are due to wide variations in the structure of housebuilding industries across Europe and also to what types of dwelling are being built - large urban regeneration schemes, for example, take longer to switch off than small-scale suburban housebuilding. Other factors relate to the content of recent fiscal interventions and how much governments have used housebuilding and renovation programmes as conduits for attempts to stimulate aggregate demand. In addition, some governments have provided various inducements to encourage new property purchases, and general government stimulus programmes to revitalise economic growth may boost housing demand when they work, even if they are not directly channelled through housing.

Several European economies have been badly affected by declines in housebuilding, because of the direct downward economic impact of such large cuts in aggregate demand. The impacts were greatest in those countries which had the highest GDP shares of housing investment, Cyprus, Ireland and Spain. As per capita building rates were so high in those three countries, there was inevitably going to come a time when building would have to slow down and the economy suffer as resources were slowly put to other uses. The suddenness of the change has inevitably come as a severe shock for them. But wider economic impacts of the downturn in housebuilding have been felt even in countries like the UK that had relatively low housing outputs during the boom years, because the pace of the output collapse was so rapid.

Most European housing industries have been badly affected by the housing slump, even if the raw housebuilding data do not necessarily indicate major losses in output. Part of the reason is that there has simultaneously been a collapse of commercial property development as well and that has hurt developers building across both types of real estate, which is a common practice in continental Europe. Germany is one of the few countries that has been relatively unscathed, partly because its builders have had to face a secular decline in housebuilding for well over a decade. Switzerland managed to increase its housing output through the recession, due to a strong demand for rental property that is slowly drawing to an end.

One neglected issue about any forthcoming upturn in European housing markets concerns development finance needed for land purchase, the physical and regulatory preparation of that land, and for subsequent construction. Real estate development finance has been badly affected by the financial crisis and no end is in sight. Attention is being paid to the health of mortgage markets used by investors and homeowners but developers, especially smaller ones, are reliant on direct bank loans and have to use risky and non-transparent assets as collateral in the form of land and work in progress. Such asset types are now downgraded and anathema to lenders. What is more, lenders themselves are going to face much higher costs in lending to development activities because of regulatory changes in capital requirements. Traditional sources of residential development funding are therefore likely to be far scarcer in the future than they used to be.

An associated issue relates to development land. Bank asset restructuring programmes contain significant amounts of development land that was foreclosed on by lenders and much more is held by companies who survive only through lender loan forbearance. So, in most European countries in this crisis there has not been a flood of development land onto markets at knock down prices that other financially stronger builders could build on quickly to sustain a recovery in housing supply. Development land is already heavily regulated in Europe's land-use planning systems, so any loss of readily available sites is going to have a major impact on recovery.

The outcome of these development finance and land problems is that there is a serious risk that the next recovery in Europe will be a very low supply one. In many European countries, a lack of good quality, well-located housing has been a prolonged, seemingly irresolvable issue. It may be even more generalised over the next few years, helping to create the conditions for yet another price boom and bust cycle.

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Why most of Europe may be avoiding the USA's prolonged housing market meltdown

There are several reasons why many European housing markets have adjusted relatively quickly to sudden negative shocks. European countries have automatic stabilisers when their economies start to slide; ones that are fairly strong relative to those in the USA, given the strength of welfare states, job protection and unemployment pay schemes. Some of them directly affect housing markets, for example, with income support schemes which dampen the scale of mortgage default.

There is also far less stress on trying to draw low income households into homeownership in most of Europe, and it was a variant of that on-going American policy that helped to trigger the sub-prime crisis. For better or worse, European low income housing programmes tend to emphasise to varying degrees subsidised social housing provision, rent controls, and support with rental payments. Where they exist in Europe, low income homeownership programmes come with a lot more subsidy, which directly lowers entry costs, and also comes with far more scrutiny because of the types of agency used to deliver such programmes, which helps to limit fraud. Most of the mortgage borrowers in Europe come from the more prosperous sections of society. They may borrow extensively but are less likely to default in tough times.

What is more, the penalties for failing to keep up with mortgage payments are far higher than in the USA, giving borrowers less of an incentive to default. Public sector mortgage default rescue schemes plus additional co-operation from lenders in limiting repossessions are also common. So, the incentive for borrowers is for them not to walk away from mortgage commitments and homes, even when there is substantial negative equity. Defaults have risen across Europe, though at a much lower rate than in the USA, where the delinquency rate on residential mortgages (i.e. more than 30 days due) had reached 8% by the first quarter of 2009, according to the Federal Reserve. So, distressed sales by existing homeowners in Europe have been far less, in marked contrast to US experience. This is helping to limit price decline.

A further key difference from the USA is that housing market problems there preceded the general financial crisis and recession, whereas they were more closely linked with it in Europe. This has meant that it has been easier for European policy makers to put in place positive actions with respect to their housing markets and for households to adjust their budgets. General economic and monetary policy more rapidly flowed in the same direction as the housing market. Those factors obviously could not stop the downturns, rather they were manifestations of them, but they have contributed to limiting the strength and persistence of decline. With hindsight, European central bankers probably fought the battle against inflation too long, but even so circumstances were more generally in their favour to be able to act decisively in concert with governments and their fiscal policies. Consumer expectations of falling house prices did not become so entrenched in Europe, because price falls have not gone on so long.

The supply-side in Europe was also more favourable to the avoidance of severe market crashes. In many countries, housing supply responses had been relatively meagre in face of substantial increases in price, which is one reason why prices rose as they did. A paradoxical advantage of this is that there was less supply left unsold once demand fell sharply in the current downturn. What stocks there were could be run down fairly quickly before they became a continuing drag on the market. Builders could then redirect their efforts to building homes that would sell once the recovery began and, thus, help to sustain it; rather than be stuck with unsold properties that no-one wanted any longer. The experience of Ireland, Spain and some central and eastern European countries has been more similar to that in the USA in this supply-side respect.

The argument just made is not one that suggests building fewer houses will smooth off the housing market cycle. It is only working in Europe at this particular juncture because of other features of the cycle, particularly the low level of enforced sales from the existing stock. Limiting supply helps to create destabilising house price booms; imposes huge costs on those that want housing but cannot afford adequate accommodation at the prevailing high prices or have to sacrifice much else in order to get it; and damages economies by restricting labour mobility. Therefore, it is not such a good policy option after all.

An uncertain future

Housing markets may be recovering somewhat but the future remains uncertain. General economic recovery is fragile, as are financial systems. Programmes to replace lost funding sources for mortgages and to build up confidence in European mortgage instruments in the world's capital markets are often in their infancy at best. Competition amongst financial institutions is much diminished and they will face greater costs of doing business, which will weaken credit availability and raise interest rate spreads on a long-term basis. The regulatory future is still under debate and outcomes could have markedly adverse impacts on housing markets. What is clear is that the last boom was one of the longest and strongest on record, and is unlikely to be repeated soon, so that all players in the housing and mortgage markets will have to adjust to greater volatility; even if it is unlikely to be of the scale of the past few years.

There is some concern that recent signs of housing market recovery is a false dawn and that prices in Europe will fall again in 2010. It would be foolish to discount such a possibility altogether, particularly given current heightened risks. In any case, by no means all of Europe's housing markets are exhibiting signs of recovery.

Nonetheless, double-dips are extremely rare in housing markets. Most of Europe's economies are recovering, which tends to favour housing demand. Rising housing demand will itself quickly confront the problem of limited supply, given the persistent problems facing housebuilding industries. Mortgage finance is constrained but financial markets are improving and, in any case, monetary authorities and governments will be reluctant to risk jeopardising the recoveries in the financial, mortgage and housing markets, particularly after all the effort made to put them on the path to recovery.

There are grounds for some optimism that many European housing markets are at least on the path to recovery. Nevertheless, the following heading still acts as a warning of the need for caution.

The poverty of predictions

It is inevitably hard to map and understand the details of housing market dynamics, particularly on a cross-country basis. This is especially the case as consistent and robust housing market models do not exist for European countries with which to compare the detailed dynamics of their housing markets. Few well-specified models exist and they themselves are only of limited usefulness in identifying market turning points and predicting short-term changes. For one thing, they have to rely on other predictions as forecasting inputs, such as macro-economic models, finance and demography. If they are wrong, so are housing market forecasts.

Into the bargain, there must always be some inherent scepticism about forecasting markets in which conscious human agents operate. Once they are aware of an apparently robust forecast they are likely to change their actions and alter outcomes. As a result, the downfall of a forecast may be that it was just too good at what it did.

In contrast to such forecasting approaches and doses of healthy scepticism, a number of alternative views tend to dominate popular and media discussion of house price dynamics. They are worth considering briefly because each has predicted, and continues to forecast, severe house price falls across much of Europe.

One view emphasises people's price expectations and beliefs as the most important market drivers and mean reversion as the inevitable long-term outcome. According to this view, reckless lending and over-optimistic expectations led to bubbles in many European countries during the boom. Predictions within this framework are easy, because in such a perspective what goes up must come down. Yet, while it may be salutary to sound off against the foolishness of one's fellow human beings, either as borrowers or lenders, such a viewpoint is unlikely to be a full explanation. Expectations may play roles in housing markets but, nevertheless, housing is a costly transaction, a long-term consumption good and a prime household asset, so it is unlikely that purchases are made just on a hunch and a whim, with the market driven primarily by speculation, especially when exit costs are high.

Other analyses place faith simply in mean-reversion and stability in some fundamental ratios. These include house prices-to-incomes or housing outgoings as shares of disposable income. While some justification can be drawn from historical evidence on these ratios, they or their averages are by no means immutable constants. Cross-country, regional and city comparisons reveal wide cross-sectional variations in them. So, any stability over time has to be explained rather than taken as datum. Divergences from given values of such ratios consequently do not necessarily indicate the need for a subsequent re-adjustment. Mean reversion is open to critical scrutiny. Real interest rates still remain substantially below mid-1990s levels, for example, and supply side problems in many European countries continue to worsen.

A final approach which grew in popularity during the boom years is to specify simple dynamic models of housing markets with limited but common sets of demand-side only factors and then estimate the coefficients for individual countries using the available data. Outputs from such models include estimated 'equilibrium' house prices that can be used to calibrate whether actual prices are over or under-valued at a point in time and likely to experience 'correction'.

These approaches are more sophisticated variants of the fixed ratios one and, like them, they neither explain why the estimated values are appropriate nor why they represent long-run equilibrium values. They differ from more complex housing market models by having incomplete theoretical underpinnings, missing variables, and potential data weaknesses.
Most glaringly, they ignore the supply side.

They may be useful in offering a starting point for discussion over differences between housing markets but cannot by themselves adequately evaluate or forecast what is actually happening. The IMF promotes forecasts from such models in its bi-annual *World Economic Outlook* to the consternation of some in Europe worried about the potential impact on market expectations.

This is not to say that forecasting, even in simple forms, has no place in understanding housing market developments: far from it. After all, this is one of the rationales for this review. The point instead is to suggest that theory and practicality need to be combined and holistic views taken of market developments.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

This chapter provides brief summaries of contemporary housing market conditions in each of the ten countries surveyed in detailed country chapters. It aims to provide a snapshot view for those who do not wish to read each chapter in detail.

Cyprus

The slowdown in the housing market observed in 2008 intensified in 2009. Unfortunately, until a proper official index is made publicly available, house price developments in Cyprus will remain a guessing game.

Other indicators are mixed. Building permits, a forward indicator of housebuilding, showed a relatively moderate fall to September 2009 of 9% year-on-year. Transactions data from the Cyprus property registries are the starkest indicator of a sharp decline. In 2009, excluding December, sales were down 47% on the previous year, which itself had seen marked falls from 2007 levels. The biggest declines were related to foreign buyers. This fall reflects the general bursting of the holiday homes bubble around the Mediterranean as a whole and Cyprus specific aspects as well.

The earlier housing boom was most easily identified on the supply side. Housebuilding levels from 2005 to 2008 were extremely high. From an already high building rate of 7 dwellings per 1,000 people, it rose to peak at 22 dwellings in 2006 and stayed at that high level of the next two years. This was the highest housebuilding rate in the EU; surpassing even Ireland and Spain during their building booms. Cyprus may not escape unscathed as housebuilding rates fall back to more normal levels. Falling tax revenues from house sales and capital gains taxes have already had a big impact on government income.

A sustained period of housing market retrenchment may now occur. There was some talk of bottoming out towards the end of 2009 as some buyers entered the market with the prospect of apparently good bargains. But commentators still did not see much hope for 2010, with a flat or contracting economy; a risk of higher euro zone interest rates at some time during the year; and a supply overhang.

France

The long boom in house prices ground to a halt in the summer of 2007 and they had fallen 10% from their peak by the end of 2008, according to FNAIM. In q1 2009, there was a similar picture of falling prices, but by spring the market seemed to pick up slowly and in q3 2009 they were 2% above their earlier winter levels, though still 8% down on the year before. October 2009 showed continued price stability.

Other house price data shows a similar picture. The official INSEE existing house price index, which is based on notaries' transactions, tends to lag the FNAIM asking price index by 3-6 months. It indicated that prices peaked in the first half of 2008, after which they fell. So, there are grounds for thinking that the worst of the market decline may be over, especially as the economy as a whole came out of recession in the third quarter of 2009.

In terms of transactions and housebuilding, the market continued to slow significantly during 2009, at least until the summer, according to the latest available data. Transactions of existing homes fell by an estimated 24% in the year to June 2009, according to CGEDD. Housebuilding was also in retreat, after a marked surge in the final years of the boom. Housing starts declined by 17% in the year to October 2009, though they were still high relative to many other Europe countries at 340,000 units. There have been some regional differences in housing market performance but housing market retrenchment has affected the country overall.

Mortgage loans grew by a tenth on an annualised basis in 2008 up to October; the rate of growth then slowed through 2009 but was still 4% higher by October, according to central bank data.

As a result of the economic crisis, the government aimed to spend €340 million on a variety of schemes to boost the housing market and housebuilding as part of a wider stimulus package. They include a 100,000 social homes building programme during 2009 and 2010, and private housebuilding is being boosted through a two-fold increase in zero interest rate mortgages for the purchase of new housing by first-time buyers until the end of 2009, and €50 million support for local authorities to fund 30,000 “Pass-Foncier” which provides up to €50,000 to those on moderate incomes to facilitate new house purchases and which also provides a loan guarantee scheme. Matched funding of €350 million was also made available to restart stalled private housing projects and a further €200 million for repairs and energy improvements to existing homes.

The French housing market, like most others, is no stranger to booms and slumps. House prices in the first half of the 1990s fell by around a third in real terms. So, the current one looks like it is going to be a relatively mild one in price terms, assuming no further shocks come along. Even so, recovery is likely to be lacklustre for some time.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Germany

The housing market has not had the same degree of convulsions as has occurred in many other countries over the past couple of years. Even so, there was some downward movement in nominal prices with the Hypoport hedonic index registering a 2.4% fall on the year in October 2009. As the owner occupied housing market is fragmented in Germany, a better picture is perhaps given by a breakdown into building types in the Hypoport index: prices were down -3% for apartments; -5% for existing houses and static for new homes. (The new homes index tends to track construction costs, rather than housing market forces, as much is self-build).

These declines seem to be weighted towards the early part of 2009, with some firming of prices in the second half. New build data also suggest the worst may have occurred in the first few months of the year, with September housing permits granted 10% up on the year before. However, the business climate in residential construction was still deteriorating towards the end of 2009 but by nothing like the scale of most other European countries. The prognosis remains for only limited house price change over the next few years.

The world financial crisis did not pass Germany by. Fears of bank runs in autumn 2008 forced the government to offer guarantees on bank deposits. Some institutions have also had to be rescued and other banks had state injections of capital and have been put under pressure to restructure. There was better news for mortgage finance overall in 2009, as the major source of mortgage funding, the 'Pfandbrief' covered bond market was again functioning effectively after severe problems in autumn 2008.

A major benefit for the housing market is that the economy has turned around quickly after the severe drop in 2008 and early 2009, helped by fiscal stimulus programmes and lower interest rates, which kept up consumers' expenditure.

The German housing market remains oddly distinctive in its performance. Real house prices have slowly fallen on a year by year basis since the mid-1990s and no end yet seems in sight to this remarkable trend. Germany completely missed out on the long housing market boom of the late 1990s and 2000s experienced by most other countries (with Japan being the other major exception). This situation has led to some starkly different trends. German house-price-to-income ratios have fallen by almost a third since the early 1990s and the price-to-rent ratio has also fallen significantly over time, as rents have tended to keep up their real levels and even to rise. Obviously, these observations are at the national level and partly affected by experience in the new Länder. Some cities, like Munich, have experienced more buoyant situations but nothing on the scale of other major European cities.

With long-term falling real house prices, it is unsurprising that there has not been a rush towards owner occupation. In addition, long-term tax and subsidy changes have depressed both investment and owner occupied housing demand. Expansion of owner occupation in a country with a majority of renters is also likely to remain a gradual process at best, though once again an incoming government has pledged to expand the tenure. The most recent official survey showed the homeownership rate remaining stable: having dropped slightly from 43% in 2002 to 42% in 2006.

Recent performance has been influenced by three factors distinguishing the housing market from those in many other European countries. The first is the unusually large role played by renting, with owner occupation the minority tenure. Second, new supply seems elastic and plentiful by European standards. Finally, the country's mortgage market has not been subject to any significant structural or competitive changes in recent years and borrowing terms were not loosened much and so the credit surges seen elsewhere did not occur.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Hungary

The housing market was pulled by a variety of distinct pressures in 2009. The first and most important, of course, was the impact of the world economic and financial crises, which hit Hungary particularly badly and led to the calling in of the IMF and the introduction of an austerity programme. The second was that, unlike many other European countries, mortgage interest rates have not fallen, rather the reverse; especially for forint denominated loans. Finally, the government announced several key housing related subsidy cuts and tax increases several months before implementing them, which led to the bringing forward of market activity to the first half of the year. As an overall result, the first half of the year did not look too bad considering the circumstances but the second half turned out to be much worse.

Hungary's period of booming house prices was earlier and less sustained than those of most other central and eastern European countries in the 2000s. Prices did increase between 1998 and 2001, but then price growth gradually petered out as vote-winning subsidies were withdrawn and fiscal austerity caused a sharp reduction in economic growth.

The FHB House Price Index shows national prices pretty much static between 2004 and 2007 in real terms, before gradually sliding into negative territory between the beginning of 2007 and the middle of 2009, when they were 11% down on the year before in real terms. More recent data from the agency Otthon Centrum shows sharp falls in transaction prices in the second half of 2009. For example, family houses were down 25% from the summer by November in Budapest and 23% in the country as a whole. These data are from a smaller sample and are not quality-adjusted, unlike the FHB ones, but indicate a sharp deterioration in the housing market. Housebuilding data from the central statistical office tell a similar depressing story.

Growth is not expected to return to the economy until 2011. The bringing forward of housing demand through the fiscal measures of 2009 may, by inducing subsequent sharp price falls, unwittingly help to intensify negative price expectations and further prices falls in 2010. Alternatively, prices may bounce back somewhat as activity rises again. So, the forthcoming year is one of particular uncertainty for the housing market and the economy in general.

The use of mortgages has expanded rapidly in recent years from a very low base. However, the total loan book is not much above 10% of GDP. Over the last few years, borrowing in foreign currencies has eclipsed borrowing in Hungarian forints (HUF) because of the much more attractive interest rates on offer. The amount of outstanding household loans denominated in foreign currencies has now risen to over 60% of the total.

This represents a significant exchange rate risk to some households' finances and to the housing market in general. However, the risk of major exchange rate convulsions declined during 2009, following support from the ECB late in 2008 and the adoption of an IMF programme.

Italy

House prices declined in 2009 but on a relatively moderate scale compared to some other European countries. They were down by 4% in nominal terms, according to both Nomisma and Scenari Immobiliari and the moderate downswing is likely to continue into 2010, before prices level off. This is mainly due to the continued weakness of the economy, because homeowners are relatively debt unencumbered, credit is still available, interest rates on loans are cheap, and there is no supply overhang to worry about.

The absence of a major crash is due to several factors. For one thing, the previous boom had been relatively modest and concentrated in the five year period after the introduction of the euro.

Housebuilding numbers tend to be difficult to forecast accurately because of the scale of building that takes place outside of the formal building control framework but informal building is undertaken to order, which limits the threat of supply overhangs. This institutional framework helps to keep housing supply relatively plentiful.

The conservative banking system was not badly affected by the financial crisis, particularly following ECB support. Mortgages are far less important influences on purchase decisions than they are in many other countries but they have remained plentiful for those that fulfil lending criteria. Even so, transactions still fell by 15% in 2009.

The economy was one of first to be badly hit by the economic crisis and had slid into recession already in 2008. The downturn intensified in 2009 but recovery started in q3 2009. Interest rates dropped sharply in 2009 for variable rate products. This encouraged some house purchases, partly offsetting the contemporarily negative economic drivers.

Netherlands

The resilient Netherlands housing market finally cracked in the autumn of 2008. Transaction volumes had been drifting slowly down since 2006 but then dramatically dropped by a third and house prices started to decline. However, the price decline turned out to be relatively moderate, falling by 6% between August 2008 and September 2009 - with a slight upturn during the next month. So, the market seemed to be stabilising by the autumn of 2009 but remains fragile.

Housebuilding has been affected by the slowdown. Permits for new owner occupied homes fell by 18% in the first half of 2009 compared to a year earlier. Yet, total completions were only down by a modest 4%, helped partly by an increase in social housebuilding.

The relatively muted downturn in house prices to date occurred despite the substantial impact of the financial crisis on the economy and financial system. Banks sharply tightened mortgage lending criteria, and households showed less interest in borrowing as confidence in the housing market declined. Mortgage lending growth declined throughout 2009, though according to the central bank still rose somewhat.

The country has been badly hit by the economic downturn and the economy was set to decline by almost 4.5% in 2009 and to remain flat during 2010. Unsurprisingly in the circumstances, unemployment is on the rise, though from low levels.

Poland

House prices continued to drift downwards in 2009. There is neither an official house price index nor a quality-adjusted one, so reliance has to be made on asking price measures. They show prices down by about 10 to 15% from their peak levels, with considerable variation in price falls between the major cities. Turnover in residential markets is much reduced. For example, the Warsaw new homes market is only turning over at 40% of the 2007 level, according to REAS. There are extensive stocks of unsold new dwellings, which are further softening prices. New credit constraints on large mortgages have hit the luxury flat market.

Mortgage markets continued to expand though at a reduced rate. Much mortgage borrowing has been in foreign currencies, which intensifies the risks. However, typical mortgage repayment to income ratios are not too large, suggesting that many households still have significant financial cushions to assist them in avoiding default, and low interest rates are helping as well.

The economy has helped to cushion falls in the housing market, as it has not gone into recession, unlike the rest of Europe. This has meant that unemployment has not risen that much. Moreover, the decline in the housing market has been relatively moderate compared with experience elsewhere in central and eastern Europe.

The government has recently introduced a programme to support housing demand in face of the slump through a “family in own home” policy, which provides mortgage interest subsidies for first time buyers. It works most effectively for those buying smaller units in the existing dwellings market. Measures have also been introduced to encourage more investment in private renting.

The prospect is for continued price falls in 2010, with recovery in 2011. However, there were signs that the market was bottoming out in the second half of 2009, with improved sales levels. Yet there is a lot of unsold stock to get through before vacancy rates return to equilibrium. What is more, developers have now built over 300,000 dwelling units since 2000, so that re-sales from that stock now compete directly with new build, moderating any potential for price rises.

Poland experienced sharp rises in house prices from the middle of 2005 to mid-2007, during which time prices more than doubled. At present, there does not seem to be much likelihood of a major correction back to pre-boom price levels.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Spain

The housing market downturn continued during 2009. There was some evidence that the decline might be bottoming out towards the end of the year, though the housing market and the wider economy still face substantial problems. So, it is by no means certain that the end of the housing market downturn will be reached soon.

The adverse market conditions have been feeding into official price indices. There is uncertainty and debate about the extent of the price falls that have occurred, especially in new build. The INE series for existing homes shows marked annual house price falls of 11% in q2 2009 and a decline from the 2007 peak of 16%. Other price indices also highlight significant price falls. Fotocasa's house price index recorded a 10% price fall in the year to November 2009, and a 20% decline from the peak. Tinsa's index, based on valuations, showed the most modest decline at 7% year-on-year to November 2009, with an overall 11% fall from the peak.

The extent of the market slowdown can be seen clearly in transactions data. The number of registered sales had peaked in 2006, some time before the onset of the financial crisis. But by q3 2009, recorded sales were 40% less than that peak. Though it is hard to measure the vacancy overhang, overall unsold and soon to be completed dwellings are believed to amount to over a million units; a proportion of which are holiday homes but many are primary residences.

Housebuilding has declined but from extraordinary peaks in the final years of the boom. Completions did not start to fall until late summer 2008 and then oddly levelled out in 2009. Housing starts (issued permits) reacted more quickly to changed market conditions. They had fallen to around a fifth of their previous peak level by 2009 but, like completions, they flattened out in 2009 as well. Even at that reduced level, they were still significantly higher on a per capita basis than the building troughs of other stricken European countries, such as the UK. It may be reasonable to assume in consequence that the flow of new supply still probably outpaces much reduced housing demand. A continuing threat to the housing market is overhang of unsold property that is currently being kept off the market by the behaviour of financial institutions.

Housing markets are invariably heterogeneous locationally and by dwelling type and Spain's diverse geography highlights such differences strongly. Consequently, the scale of the price changes that have occurred and the risks of further downward adjustments vary across the country and by market segment. Even so, clear risks remain with regard to the current price levels, despite nascent signs of housing market recovery.

Sweden

The fall off in house prices has been modest and only started in q4 2008, with a 4% price decline for single-family houses over the winter months. But, property prices were rising again by the spring and continued to climb throughout 2009, with third quarter prices 7% higher than first quarter 2009 ones, and back to their pre-crisis levels.

Other house price indices, such as that of Maklarstatistik, indicate even higher rates of house price increase during 2009 than the official data, perhaps because they are derived from an earlier stage of the house sales process. That source suggests that the price of flats rose by 10% in the year up to October 2009, and that houses were up by 4%.

So, it would seem that Sweden currently has one of the most buoyant housing markets in Europe, at least in price terms. Its buoyancy has been aided by very low interest rates. Average variable mortgage interest rates were below 2% late in 2009.

In contrast to prices, other indicators of housing market activity highlight that the Swedish housing market remains at a markedly lower scale of activity than prior to the recession. Sales of houses fell sharply in the crisis period, especially in the second half of 2008 and into 2009. Even though they did increase again from spring 2009, by October they still trailed 14% behind their equivalent 2007 levels.

A stimulus programme to protect employment late in 2008 pumped billions of kronor into the construction sector during 2009 and will keep on doing so in 2010. Despite this, housebuilding continued to decline in 2009, following previous sharp falls in 2008. The number of dwellings started in the year to November 2009 was 30% less overall; with much a greater decline in the single-family home sector (down 41%) than for flats.

By contrast, mortgage growth continued to be strong: up by 8% in value on the year to September 2009. A cause of the growth in mortgage demand was that existing homeowners and those wishing to renovate newly purchased properties could take advantage in 2009 of the lower tax breaks on building, renovations and maintenance introduced as part of the aforementioned stimulus package.

A combination of relatively good market liquidity, attractive borrowing costs, temporary tax breaks and renewed expectations of house price growth has helped to rekindle interest in purchasing. At the same time, supply is severely limited by a shortage of new stock and a reluctance of existing owners to sell. Rising prices amidst unusually tight supply could continue for some time.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

United Kingdom

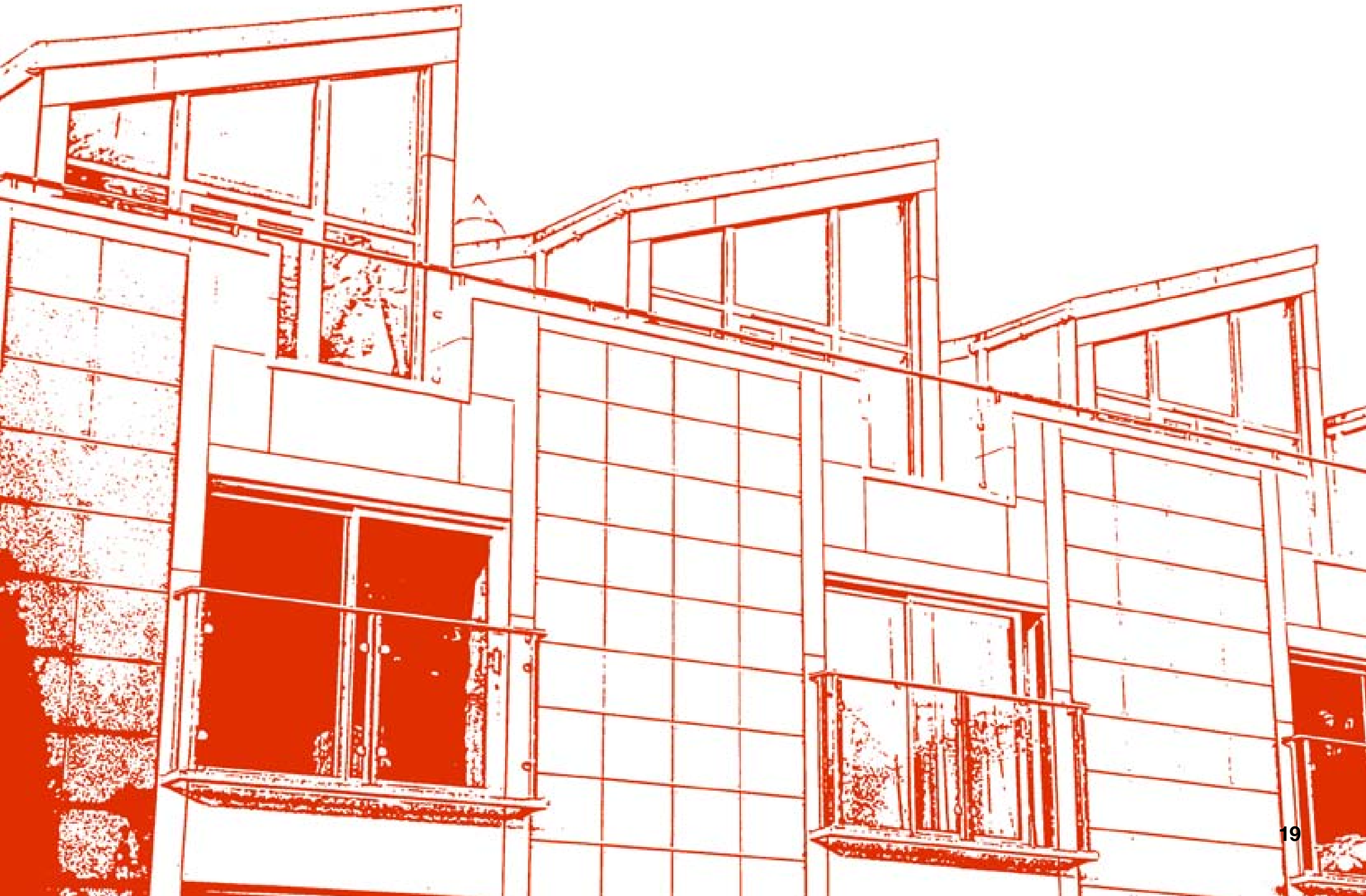
Prices in the UK market started to fall in spring 2008 and by a year later had fallen by over a fifth, according to the Halifax house price index. Yet, for the rest of 2009 they started to rise again and by the end of the year, they had grown by 8.5% from their trough. The revival of prices was greatest in London and the South East, encouraged by buyers attracted by lower prices and attractive borrowing rates, who were chasing a limited supply of good quality properties for sale.

The ratio of house sales to the stock of unsold properties on surveyors' books increased for the eleventh consecutive month in November 2009, according to the RICS monthly survey. This activity was reflected in completed transactions, up by over 10%, and mortgage approvals were almost 80% higher in October 2009 than they had been a year before.

Overall, however, the market remained very subdued compared to the final years of the boom. The UK experienced one of the most dramatic collapses in housing market activity with the onset of the credit crunch. The recovery figures for the last nine months of 2009 indicate as much the scale of the market collapse which occurred between autumn 2007 and spring 2009, than any true recovery in market activity. For example, mortgage approvals were still 56% below the 2006 peak levels in autumn 2009. This was partly because remortgaging has not recovered at all but also reflects the low level of market activity. However, it seems likely that the market has bottomed out.

The Council of Mortgage Lenders twice revised its prediction for 2009 of 75,000 repossessions made late in 2008 down to 48,000 by November 2009. Things have not been as bad as expected, though they are by no means good.

The UK economy stayed in recession longer than any other major economy but some degree of growth is expected in 2010. With housing supply continuing to be tight and interest rates likely to remain low, it seems unlikely that prices will dip again but activity will still be constrained, so that recovery will continue to be slow, particularly outside of London and the south east.



CHAPTER 3: CYPRUS

Overview

The slowdown in the housing market observed in 2008 intensified in 2009. Unfortunately, it is not possible to be certain what happened to prices during 2009 because the only available index, based on asking prices, stopped being estimated after q1 2009. By then, it had recorded a 2.2% drop in prices. Actual prices struck are likely to have been lower than that, given buyers' bargaining power in a falling market. But until a proper official index is made publicly available, house price developments in Cyprus will remain a guessing game.

Other indicators are mixed. Building permits, a forward indicator of housebuilding, showed a relatively moderate fall to September 2009 of 9% year-on-year. Transactions data from the Cyprus property registries are the starkest indicator of a sharp decline. In 2009, excluding December, sales were down 47% on the previous year, which itself had seen marked falls from 2007 levels. The biggest declines were related to foreign buyers. This fall reflects the general bursting of the holiday homes bubble around the Mediterranean as a whole, and Cyprus-specific aspects as well. However, the registries are frequently criticised for being slow and inefficient, so the data may not be that good an indicator of current market conditions, though they are widely used in that role.

The housing market had experienced buoyant conditions in earlier years. When Cyprus[1] joined the EU a few years ago, a boost was given to both the economy and the housing market, which was reinforced by accession to the euro zone in 2008. In the run up to the euro, the housing market was very active and prices rose rapidly, reaching 20% annual growth rates in the quarters around the introduction of the euro. However, the asking prices for houses levelled off during the second half of 2008 and then drifted downwards in 2009 (Figure 3.1).

The earlier housing boom had been driven both by domestic and foreign demand. Cypriots were more able to buy in a buoyant economy and with a major expansion of mortgage lending in a climate of apparently greater economic certainty and stability in the euro zone. The main source of overseas buyers has traditionally been the UK, attracted by the climate, cheap lifestyle, good public facilities and widespread use of English. Towards the end of the housing boom, Russian and other purchasers became more prevalent. But foreign demand fell sharply in the face of the world financial crisis.

The boom was most easily identified on the supply side. Housebuilding levels from 2005 to 2008 were extremely high. From an already high building rate of 7.4 dwellings per 1,000 population, it rose to peak at 21.7 dwellings per 1,000 population in 2006 and stayed at that high level for the next two years. This was the highest housebuilding rate per 1,000 of population in the EU; surpassing even Ireland and Spain during their building booms. The country's housing stock has expanded by over 30% in the past decade. Both Ireland and Spain have suffered badly from an excess of unsold housing since the collapse of their housing booms and for them the general economic impacts of a loss of construction activity and negative housing wealth effects have been considerable. Cyprus may not escape unscathed either. Falling tax revenues from house sales and capital gains taxes have already had a big impact on government income.

A sustained period of housing market retrenchment may now occur. There was some talk of bottoming out towards the end of 2009 as some buyers entered the market in pursuit of apparently good bargains. But commentators still did not see much hope for 2010, with a flat or contracting economy; a risk of higher euro zone interest rates at some time during the year; and a supply overhang. Recorded housebuilding is still at high levels, despite the slowdown, and so is likely to fall further. The government offered assistance to the construction industry in a late 2008 €52m stimulus package but, all the same, job losses are high.

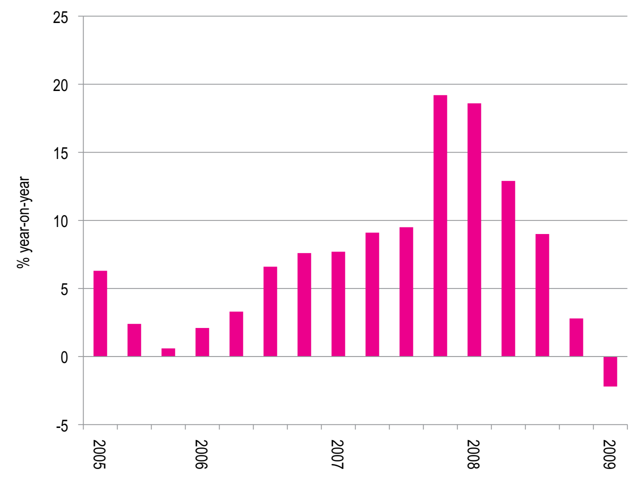


Figure 3.1: House price developments, 2005–2009

Source: Adapted from BuySell Home Price Index, S. Platis Economic Research

[1]*This chapter refers only to the Greek part of the island.*

CHAPTER 3: CYPRUS

Housing system

General housing quality is high. Space standards are some of the best in the EU and much of the stock is modern and well-provisioned. Over half of all dwellings have been built since 1980. Growth has continued to be rapid in recent years with the dwelling stock rising by 30% in the decade up to 2007[2].

Owner occupation is around the EU average at 68% and many houses are owned outright. A further 14% are conventionally rented in the private sector. However, the tenure structure is complicated by the aftermath of the division of the island into the Greek and Turkish areas, which has led to a variety of atypical tenure categories, such as refugee estate, a Turkish Cypriot house, and self-help schemes aimed at refugees. These other categories depress the percentage shares of the more conventional tenures (Table 3.1).

40% of the 340,000 dwellings are detached, another 30% are semis, 20% are apartments and a further 10% are in mixed-used buildings. The stock of housing has been growing fast with a 31% increase between 1996 and 2006. 16% of households are 1 person, 27% are 2 person and the other 57% are 3 or more persons[3]. So, household sizes are typically much higher than in northern Europe, although this characteristic is masked by the high number of holiday and retirement homes in the stock.

Average recorded housing costs as a percentage of household income are the second lowest in the EU – after Malta. They are only 13% of household consumption, compared to the highest cost country, Denmark, where they are 30%. (These Eurostat estimates include imputed rental income for owner occupied dwellings.)

Rents in the stock have been rising at 3-4% in recent years, somewhat above the general rate of price inflation. Rental dwellings are quite spacious at 116 square metres on average.

Roughly 10% of the population are non-Cypriot residents, according to the 2001 census, and the share has risen since then. Greek nationals represent a quarter of them. British people make up almost a fifth of the foreign residents, followed by smaller numbers of Russians and people from Sri Lanka and handfuls of other nationalities. Foreign residents enjoy special low income and inheritance tax rates. The British are the stalwarts of the retirement and second-home markets.

The use of apartments primarily for rented tourist accommodation has been on the decline. Their number fell by 10% in the decade prior to 2001, as holiday makers increasingly opted for full-service hotel accommodation or their own second home, which they, of course, may rent out for all or part of the season.

Second homes numbered around 40,000 in 2001, after major expansion in the 1990s. That figure is likely to be much higher now.

Stamp duty and transfer taxes are levied on purchases; building is subject to the standard 15% rate of VAT, although this is offset by government grants for properties of less than 250 square metres; capital gains are taxed at the time of sale; and there is also an annual property tax, rising in steps to 4% for the most expensive properties. Transactions difficulties have been reported. There are complaints of delays in registering title in the Land Registry, said to run into years in some cases, though the government has been taking the criticisms seriously. More staff have been hired by the Land Registries, and the slowdown in the housing market will also take the pressure off. Furthermore, the English language press has reported stories of unscrupulous developers and estate agents thriving in the holiday home building boom and of purchasers being left bereft by failing builders in the downswing[4].

There is a policy emphasis on promoting owner occupation. To this end the government offers a variety of schemes aimed at low-to-middle income families. They provide tax benefits, subsidised prices and low interest loans. There are also programmes to improve the housing conditions of those 12,000 or so households still living on refugee estates. They were planned to rise to €112m in 2009.

	%
Owner occupied	68
Rented	14
Free	6
Refugee estate	6
Self-help housing scheme on government plot	4
Turkish Cypriot house	2

Table 3.1: Tenure patterns

Source: 2001 Census

[2] *Cystat.*
[3] *2001 Census.*
[4] *See, for example, Waring, Financial Mirror, 24 January 2007 & Cyprus Mail 29.9.07.*

CHAPTER 3: CYPRUS

Housebuilding

The country currently has a high housebuilding rate relative to population, at 21 dwellings per thousand population (in 2005); a level only matched by Ireland at the peak of its recent boom. In the boom years, more than 6% of GDP was devoted to housing investment annually, significantly more than the EU average. This high level of building reflected the island's status as a holiday and retirement destination.

The rate of housebuilding dipped in the late 1990s and 2000 but then rapidly accelerated to 16,700 units per annum in 2007, over three times the 2000 trough level (Figure 3.2). During the boom years, properties were sold off plan and new developers entered the buoyant market. Now, it is reported that this practice is rare and that some sites have been abandoned; stocks of unsold dwellings have mounted; and firms have gone into liquidation[5]. The number of dwellings for which building permits were issued was 9% lower in the first 9 months of 2009 than in the previous year[6].

The high rate of building put pressure on per square metre residential construction costs during the boom years. They rose by 29% between 2002 and 2007 but costs may have been dampened as the slowdown began to bite in 2009[7].

Macroeconomic influences

GDP per capita is now only 4 percentage points less than the EU average because of consistently good growth rates since accession to the EU, followed by the joining of the euro zone area in 2008[8]. Between 2004 and 2008, growth averaged around 4% a year. Tourism is a major part of economic activity and, so, growth is sensitive to economic performance in the countries from where tourists and property buyers come. For example, the economy slowed in the early 2000s, following a downturn in the tourist industry, but recovered quickly. But this characteristic makes the economy sensitive in economic cycles elsewhere, with a lag, and this seems to be happening now again.

The economy weakened as the world financial crisis intensified in autumn 2008 and because of a loss of price competitiveness. However, it has held up better than most with a GDP fall of less than 1% in 2009, according to Eurostat, but it continued to deteriorate as the year progressed, with a 2.5% fall in GDP posted in q3 2009[9]. The decline was mainly due to falls in construction, especially housebuilding, and tourism. Eurostat forecast that recovery will occur in 2010-11 but that it will be weak.

High euro exchange rates have affected core tourist markets. This has been particularly important in relation to the UK, the largest tourist market, where the economy is in recession and the pound has fallen significantly against the euro. Increased competition has also been felt from destinations such as Turkey and Egypt. A trend towards all-inclusive hotels has also hit local tourist services in some areas.

Inflation averaged around 2% for the four years up to and including 2007. However, the country's reliance on imports meant that prices surged to 4.4% in 2008 in the aftermath of the commodity price boom, before turning negative in summer 2009 as commodity prices weakened and the economy slowed. But the price falls were relatively short-lived and inflation was rising again in November by 1% on an annual rate[10].

During the boom years since 2004, the current account deteriorated from being roughly in balance to being in deficit by a substantial 18% of GDP in 2008, according to central bank data. The prime drivers were excessive domestic demand and high oil prices.

The level of participation in the labour market is quite high and employment growth during the boom was strong. This meant that households can generally afford to buy a home and possibly invest in housing to rent as well.

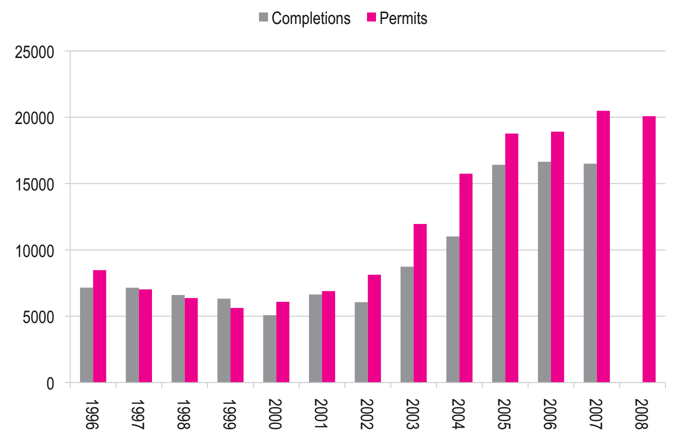


Figure 3.2: Housebuilding, 1996–2008

Source: Cystat

[5] *See Cyprus Property News.*
[6] *Cystat.*
[7] *Cystat.*

[8] *Eurostat.*
[9] *Cystat.*
[10] *Cystat.*

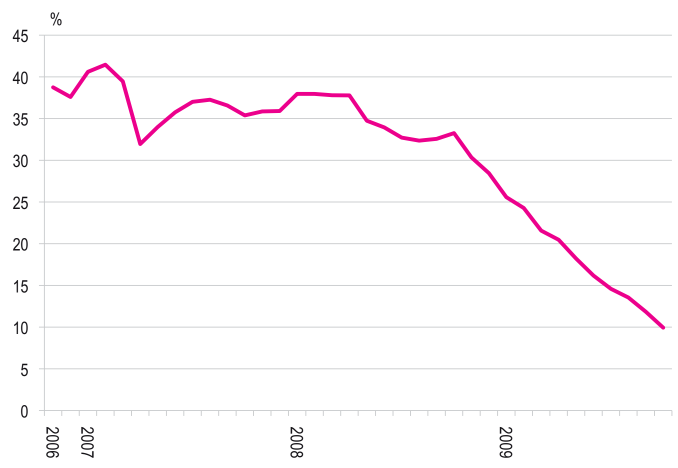


Figure 3.3: Housing loan growth rates, Nov 2006–Oct 2009

Source: Central Bank

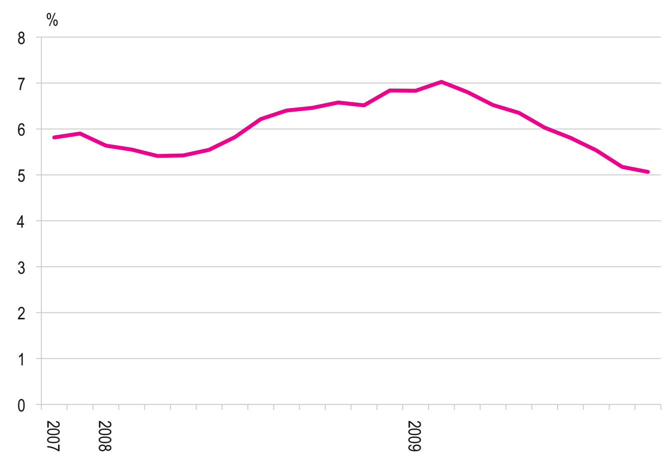


Figure 3.4: Housing lending rates, Nov 2007–Oct 2009

Source: Central Bank

Mortgage market influences

Traditionally, limited recourse was made to mortgage borrowing but that has now changed. In the past few years, housing lending has risen by a third or more each year, so that outstanding housing loans were three times higher in October 2009 than they had been in December 2005[11]. However, the mortgage growth rate declined sharply in 2009 as banks tightened lending criteria and demand fell in face of housing market and economic decline (Figure 3.3).

Unsurprisingly with such rapid expansion, the mortgage debt to GDP ratio has risen fast and reached 50% in 2008 from a very modest level a few years previously[12]. The household debt ratio as a percentage of GDP reached 122% in 2008, up from around 100% in March 2006. Consumers have been borrowing for a variety of reasons, as only 45% of their borrowings are related to loans for house purchase. Around 9% of mortgage loans are denominated in foreign currencies, mainly in Swiss francs. Wide sections of the population borrow. Surveys have shown that young households tend to have low mortgage levels and are frequently in receipt of parental gifts to fund their housing. Non-performing loans were 4.4% of outstanding loans to private households in March 2009, a slight decline from the year before[13].

Commercial banks are the main providers of loans. They have been offering extended repayment terms with lower down payment ratios. Competition has been intense, helping to account for the large rise in lending. Interest rates rose from spring 2008 to peak at 7% in February 2009, which helped to account for the slowing of the housing market (Figure 3.4). They fell by almost 200 basis points over the next seven months to October, but whether that reduction will be sufficient to offset the decline in housing demand is uncertain, given all the other factors weighing down on the market. Loans are typically offered on a variable or short-term fixation basis and tend to be noticeably higher than for similar products in many other euro zone countries.

[11]Central Bank.
[12]European Mortgage Federation.
[13]Central Bank research paper.

Demographic influences

Population growth has been fast in recent years but it is slowing now, mainly through less inward migration (Table 3.2). There was a surge in net migration in the years up to joining the EU but it has tailed off since then and was forecast by Eurostat to drop below a thousand in 2009. Over the past decade, the number of people living in Cyprus has expanded by 106,000, a 15% increase. Interestingly the surge in immigration occurred prior to the period of highest house price increase, suggesting that most foreign purchases in recent years have been associated with holiday accommodation and second homes rather than with permanent moves.

Population forecasts assume a substantial rate of increase, with another 134,000 people added until 2020; and a further 117,000 to 2030. If this prediction turns out to be true, it would make Cyprus the country with the highest population rise in the EU – growing by almost 60% up to 2050. Whether people will actually continue to come and live in Cyprus on such a scale is inevitably subject to uncertainty and speculation. Potential resolution of the problem of the divided island would lead to further substantial population changes in particular localities.

The fertility rate is low at 1.4 births per woman, down from 2.5 in 1980. Furthermore, most immigrants are middle-aged or older. The consequence is that the population is ageing rapidly. The currently dependency ratio is 18 (i.e. number of over 65s as a percentage of those aged between 18 and 65) and it is expected to more than double to 38 by 2050[14]. Those aged over 80 will quadruple over the same period.

Housing needs will obviously change with such a transformed population structure. There will also be substantial strains on public sector budgets in a variety of ways and taxation may have to rise to pay for them. Given forecasts of the number of elderly, the government-based pension system could reach a fifth of all public expenditure by 2050; which is a substantial 13% of GDP compared to less than 3% in the EU as a whole. The island's image as a cheap, low tax haven would come under considerable stress as a result.

Thousands	2000	2001	2002	2003	2004	2005	2006	2007	2008
Population	690.5	697.5	705.5	715.1	730.4	749.2	766.4	789.3	796.9
Net migration	4	4.6	6.9	12.3	15.7	14.4	8.7	7.4	3.6
Population growth	7	7	8	9.6	15.3	18.8	17.2	22.9	7.6
% population growth	1	1.1	1.4	2.1	2.6	2.3	2.2	3	1

Table 3.2: Population developments, 2000–2008

Source: Eurostat

[14] *Eurostat.*

CHAPTER 3: CYPRUS

Factfile: Cyprus

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
0 .8	1.4	1.4	78

Background

* Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU25=100)	91	90	92	96	-
Real GDP growth %	4.0	4.0	5.1	3.6	-2.5*
Inflation – consumer prices % (HICP)	2.0	2.2	2.2	4.8	-
Employment rate % (15–64 yrs old in work)	68.5	69.6	71.0	70.9	70
Labour force growth	3.8	3.6	1.7	-	-
Unemployment rate %	5.2	4.6	4.0	3.6	5.4*

Economic

*October

Sources: Eurostat, Cyprus Statistics Office, Cyprus Central Bank.

CHAPTER 4: FRANCE

Overview

The long boom in French house prices ground to a halt in the summer of 2007 and they had fallen 10% from their peak by the end of 2008, according to FNAIM. The first quarter of 2009 showed a similar picture of falling prices, but by spring 2009 the market seemed to pick up slowly and in the third quarter of 2009 they were 2% above their early 2009 level, though still 8% down on the year before. October 2009 showed continued price stability. The winter period 2009-10 may see a slight fall in seasonally unadjusted data, as market activity typically falls off during the winter months. Other house price data shows a similar picture. The official INSEE existing house price index, which is based on notaries' transactions, tends to lag the FNAIM asking price index by 3-6 months. It indicated that prices peaked in the first half of 2008, after which they fell. There are grounds for thinking that the worst of the market decline may be over, especially as the economy as a whole came out recession in the third quarter of 2009.

In terms of transactions and housebuilding, the market continued to slow significantly during 2009, at least until the summer, according to the latest available data. Transactions of existing homes fell by an estimated 24% in the year to June 2009, according to CGEDD - so by then they were 30% down from their 2007 monthly peak. Housebuilding was also in retreat, after a marked surge in the final years of the boom. Housing starts declined by 17% in the year to October 2009, though they were still high relative to many other European countries, at 340,000 units. There have been some regional differences in housing market performance but retrenchment has affected the country as a whole.

The credit crunch initially had only a limited impact on the French housing market. Mortgage loans grew by a tenth on an annualised basis in 2008 up to October; the rate of growth then slowed through 2009 but was still 4% by October, according to central bank data.

The government tried in the second half of 2008 through a variety of initiatives to stimulate housing demand and limit repossessions. The aim was to expand bank lending following the October crisis period. A supply overhang, paradoxically increased by earlier government measures to expand supply, may delay full recovery.

Prior to 2007, the housing market had been one of the booming areas of Europe, with significant price rises occurring for a decade. In fact, real house prices doubled between 1996 and 2006. However, the rate of price growth actually peaked way before the onset of the credit crunch in the summer of 2004, at 16% a year, and following that price inflation gradually subsided (Figure 4.1). Such a trajectory still gave some hope for a housing market soft landing in 2009. Yet that prospect diminished in the last months of 2008 as a lack of mortgage finance took over the fortunes of the housing market.

Towards the end of the boom demand was boosted somewhat by the fulfilment of a presidential election pledge to reintroduce mortgage interest tax relief. Under the new arrangements households can deduct 20% of mortgage interest rate repayments for five years, with an annual cap set at €3,750 for singles and €7,500 for couples. Some of these tax breaks are likely to have been quickly capitalised into house prices.

The government aimed to spend €340 million on a variety of schemes to boost the housing market and housebuilding as part of a wider stimulus package. They include a 100,000 social homes building programme during 2009 and 2010, and private housebuilding is being boosted through a two-fold increase in zero interest rate mortgages for the purchase of new housing by first-time buyers until the end of 2009, and €50 million support for local authorities to fund 30,000 "Pass-Foncier" (These schemes are explained in more detail later). Matched funding of €350 million was also made available to restart stalled private housing projects and a further €200 million for repairs and energy improvements to existing homes.

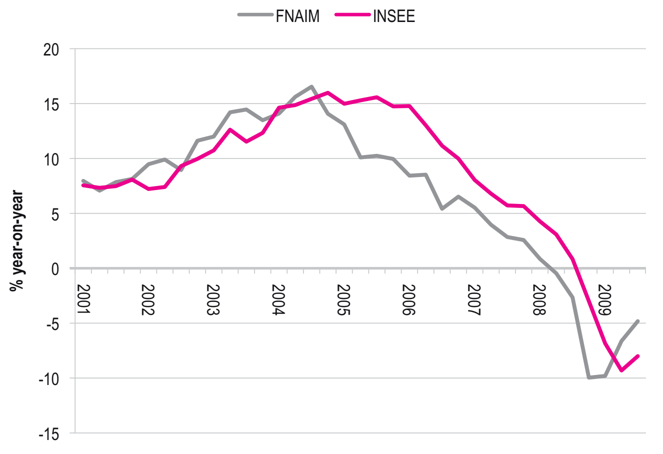


Figure 4.1: Changes in house prices, 2001–2009 (Existing dwellings, nominal)

Source: FNAIM, INSEE

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The French housing market, like most others, is no stranger to booms and slumps. House prices in the first half of the 1990s fell by around a third in real terms. In fact, marked real price declines have been a common experience of most previous downswings, so the current downswing looks like it is going to be a relatively mild one in price terms, assuming no further shocks come along. Even so, recovery is likely to be lacklustre for some time.

In a country where long-term fixed rate mortgages predominate, the housing market is only indirectly affected by ECB interest rate changes. Instead, developments in long-term interest rates are of greater importance. As in other euro zone countries, ECB purchases of financial assets have played an important part in improving liquidity in the mortgage market.

The housing system

France has 32 million dwellings: 84% are prime residences, 10% second homes and 6% are vacant. Of prime residences, 57% are owner occupied, 24% privately rented and 18% social rented. The basic quality of housing is good, although there are some notable problems as indicated, for example, by the fact that a fifth of dwellings show signs of dampness[1].

There has been a long history of strong state involvement in housing - both in renting and owner occupation - through subsidies, tax breaks, land use policies, rent controls and financial regulation. Although some forms of state involvement have declined substantially over the past twenty years, the tradition of strong state intervention remains - as seen in active programmes with regard to social housing; stimuli to investment; cheap mortgages; savings for housing; planning; renovation; and urban regeneration. A special housing construction tax on employers, the 'Logement 1%', adds around €500 million a year to the public sector's housing budget.

What is more, housing policy is deliberately used in a Keynesian way to manage demand in the economy, which is once again occurring now, as noted earlier. In fact, the aim is a stated goal of housing policy in a way rarely mentioned in other countries; though it has recently come back into fashion elsewhere as responses to the impact of the world financial crisis.

State aid is disbursed under a number of policy rubrics. There are significant programmes of urban regeneration and housing renovation as well as with respect to new build. Previously, they peaked at the end of the 1990s after which they declined in the face of public expenditure pressures, but they then grew again from 2005 with national concern over social cohesion and rundown neighbourhoods. Renovation and modernisation of the existing stock currently represents around half of all housing investment.

The urban riots of 2005 led to a strong policy response with regard to housing, which continues under the present government. A document was published 'Logement: le gouvernment s'engage', outlining more than 60 housing measures. One of them focuses on the demolition of the worst social housing and another on major renovation schemes of buildings designated to remain. An urban renovation agency manages many of the schemes (ANRU - Agence Nationale Pour La Rénovation Urbaine).

France has the largest stock of housing in the EU, when measured on a crude number per thousand population basis. Partly, this is accounted for by the relatively large number of second homes (around 10% of the stock), concentrated in the southern part of the country; and by the high level of vacancies: they have remained around 6-7% of the stock for many years. Such vacancies are associated with the continued rural to urban shift of the population and with rundown stock in older industrial areas but also with individual housing and investment preferences, which for a variety of reasons keep some dwellings officially defined as vacant. Fiscal penalties on vacant dwellings have recently been introduced in an attempt to reduce the vacancy rate, and these taxes were expected to raise €18 million in 2009.

A fifth of the stock has been built since 1980 and two-thirds since 1945. The housebuilding rate is quite high by EU standards: at 6.0 per 1,000 population in 2004 and it grew significantly after that during the final years of the boom[2]. In the 1990s, an average of almost 300,000 dwellings was added to the stock each year and output has been even higher in the 2000s. But, despite this high rate of building, shortages have remained, particularly of affordable housing in the main urban areas.

Almost 60% of the stock is individual houses - mainly owner occupied - and the rest are flats located in multi-dwelling structures, most of which are rented. 16% of the total stock exists as dwellings in high-rise buildings of 4 storeys or more[3]. Much of the social sector is located in unattractive suburban areas and many of them are still in need of substantial improvement.

[1]2006 data. National Housing Agency.
[2]INSEE.
[3]Housing Statistics in the EU 2005/6

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Owner occupation

The number of households owning their principal home started to grow noticeably during the recent housing boom after being stable for many years. In 1992, it was estimated that 54% of primary residences were owned by their occupants. By 2006, the share had risen only marginally to 57%; though it may have grown further since then. However, because the number of households has been expanding rapidly, the number living as homeowners has been rising at an accelerating rate: by 125,000 households on average a year between 1990 and 1995; by a further 163,000 a year to 2000; and by 205,000 annually to 2005. Between 1990 and 2005, there were 3 million extra owner occupiers in total; accounting for as much as two-thirds of the total net increase in the stock.

Expansion of owner occupation reflects a notably higher propensity amongst the 35 to 54 age group to opt for that tenure. Purchasing is spreading to younger households as well. The tax and subsidy system is becoming more tilted towards the tenure, which, in addition to the impact of rising living standards is encouraging such developments, especially via mortgage subsidies and tax breaks.

The current government has set itself a target of raising the homeownership rate to 70%. Achieving that aim would result in a major transformation of French society and at best must be regarded as a long-term goal, especially given the current downturn in the market. As part of this process, 40,000 social housing tenants a year are expected to become owners of their dwellings in a programme reminiscent of council house sales in the UK[4].

A subsidised mortgage loans policy exists in the form of a 'zero per cent' loan programme, known in France as the 'prêt à zero %' programme (PTZ). This scheme provides moderate to middle income, first-time buyer households with zero interest loans. Applicants are processed through the usual mortgage channels and standard mortgage loans can be given to borrowers on top of the PTZ. This has made lending to such applicants more attractive for commercial firms, as the PTZ element is state guaranteed, offering in practice a boost to the down payments that first-time buyers can make. There are caps on loan sizes, based on income, household size and national price zones.

Another recent loan scheme also aims to encourage low income homeownership, but offers more generous terms than the PTZ. It is known by the acronym NOT. Both PTZ and NOT loans now carry full government default guarantees.

The monthly income caps on PTZ loans were raised until the end of 2009 as part of the package of emergency housing measures. For a household with two children outside the Paris region, the cap was raised from approximately €2,900 to €3,750. The new terms are estimated to make 60% of households eligible for PTZ loans. This gives greater confidence to lenders as it lowers the default risk on their elements of total loan packages offered to home buyers.

Since its introduction in the mid-1990s, well over a million moderate income households have used PTZ loans. Up to 2005, they were used mainly to buy single family houses. It is common for younger French people to stay in their parents' home through the early years of adulthood. 29% of men aged between 24 and 29, for instance, still live with their parents during which time they may accumulate savings for a housing down payment. So, the PTZ scheme, by acting as an implicit deposit top-up, assists in smoothing the transition from parental home to homeownership, especially outside of the higher priced areas.

PTZ loans had been declining in use, with the number falling by 30% between 1998 and 2004. But, early in 2005 a new scheme was introduced, as part of the programme of increasing housing affordability, and the scope of the programme was extended significantly by making it available for existing as well as new housing. Further reforms in 2006 increased the loan and income caps in the more expensive areas of the country. By 2009, €700 million was being spent in the scheme[5]. Recently, an environmental programme has been added to the PTZ portfolio, with 'L'Éco-prêt à taux zéro', which can be used to finance up to €30,000 work to improve the energy efficiency of a dwelling.

Another source of financial aid to newly built owner occupied housing is the Pass-Foncier scheme, which provides up to €50,000 to those on moderate incomes to facilitate new house purchases and which also provides a loan guarantee scheme.

Overall, subsidised sources of credit are generally important in house purchase. They represented more than a fifth of total credits in the new housing market in recent years. Therefore, the recently revived mortgage interest tax relief measures are just one of several avenues for owner occupiers to benefit from state-subsidised borrowing. Further subsidies also arise in building and renovation.

[4] *Housing Ministry.*
[5] *National Housing Agency.*

It could be argued that such demand subsidies stoke housing demand, which may be good in downturns but helps to force up prices in the boom years. Their distributional impact may also be questionable, despite stated aims to subsidise those most in need. Lending on current income criteria to first-time buyers, for instance, subsidises young people on steeply rising career ladders who will have substantial resources a few years later as well as others who may be less fortunate.

Private renting

Almost a quarter of households rent privately and renters are generally located in the inner city areas of the large cities, with the greatest number in Paris. Such tenants are highly mobile: two-thirds occupy their dwelling for less than four years.

The number of privately rented dwellings has been fairly static over the past forty five years at around 6.5 million dwellings, although average quality has greatly improved over that time. The stock is relatively new in contrast to several other European countries. Nearly 60% of private rented dwellings were built after 1948 and as many as 14% after 1990, with new building encouraged by attractive renovation subsidies and land allocations. Most landlords, 93% of them, are private individuals rather than corporations, according to INSEE surveys.

Rent control exists in a variety of forms, depending on the type of property and the length of the tenancy. Under the most common form of arrangement, rents may be freely agreed in leases for new and renovated dwellings but then subsequent rent increases are linked to an official reference index. This regulation was introduced in 1989 and so is often known by that date. It has been in force for all new tenancies since 1997. About 5% of the privately rented stock is subject to strict rent control under the terms of the rental law of 1948.

From 2006, the permitted formula for annual rent adjustments switched away from the construction price index, which was rising at a much faster rate than general inflation, to a composite rent reference index (known by the acronym IRL - Indice de Référence des Loyers). The new IRL index is based 60% on the consumers' price index, 20% on the construction cost index, and 20% on an index tracking landlords' estimated costs for management and repair. The IRL grew quite substantially during 2007 and 2008, reaching almost 3% in the third quarter reflecting general inflationary pressures, but in 2009 it flattened off and even declined somewhat as inflation subsided (Figure 4.2).

For tenancies existing prior to 1997, rents are still regulated and renewals must stay at a level comparable with those for similar dwellings in the locality. There are also around a quarter of a million properties with rents that were frozen at 1948 levels. However, there has been some liberalisation and the financial situation of the owners of such properties has been improved as well.

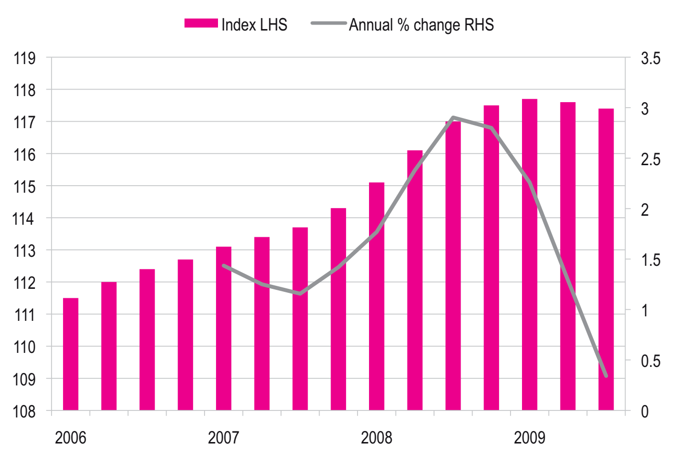

Figure 4.2: Rent reference index (IRL), 2006–2009

Source: INSEE
Note: IRL index 4q1998=100

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In the social sector, the prime determinant of rent levels is historic cost i.e. construction and other costs at the time the housing development was built. A recent study found that average social rents were 40% less than equivalent market rents[6].

Average rent increases in both the private and social sectors tend to be modest because of the controls imposed on existing contracts. Average rents have risen in nominal terms in recent years, though in real terms the increases have been quite modest. The rent rises for new contracts alone have been relatively modest in recent years as well. The country as a whole saw some buoyancy in 2007 with Paris having rent rises of 5%. However, additional supply in many parts of the country and the advent of economic recession led to a softening in 2008 and 2009, according to FNAIM.

IPD had reported strong returns for investment in residential properties up to 2007 in line with house price rises. However, in 2008 falling house prices offset the 3.5% income return to give a total return of only 1.5% and 2009 was unlikely to show any improvement.

Social Housing

At 4.4 million units, social housing is estimated to represent 19% of principal dwellings. They consist mainly of estates of flats and are concentrated in the Paris region and industrial areas in the north of the country. Around 10% of tenants move each year.

Social housing standards have improved significantly since the mid-1980s. This upgrade has involved large-scale public expenditure on refurbishment as a majority of the stock dates from the 1960s and 1970s, with only 9% built since 1990. Local authorities now have a target of providing 20% social housing in new constructions permitted in their areas and they are subject to central government scrutiny if they fail to meet it.

A major programme of social housebuilding and renovation was begun after the urban riots of the mid-2000s. Between 2005 and 2007, the construction of 276,000 social dwellings under a variety of programmes was agreed and funded. 2009 saw funding for a further 100,000, as part of the emergency expenditure package. Around 50,000 new social dwellings were added in 2007 (the latest available data), although the net increase was less than that, due to 14,000 demolitions and 10,500 sales[7].

Housing allowances are paid to tenants and to homeowners as a consequence of several pieces of legislation. The most common one, APL[8], is also used to promote access to property ownership by partly covering mortgage costs. Over 10% of owners, around a third of private sector renters, and 48% of social housing tenants are in receipt of some sort of allowance: approximately 6 million households in total funded from programmes which cost €14 billion in 2007. ALF[9] is paid to households with children, and to young couples with no children, when household income is below specified levels; while ALS[10] is paid to single people, mainly students, who are not entitled to APL.

Recent immigrants and other ethnic-minority groups comprise a significant proportion of tenants in social housing. Many live in the subsidised-rent projects run by Habitations à Loyer Modéré organisations (HLMs), particularly in the oldest dwellings. Such groups have a high proportion of large, low-income families and they experience some of the poorest housing conditions.

Housebuilding

High rates of housebuilding were clipped by the onset of the recession. The growth in housebuilding was relatively slow during the early years of the market upturn from the mid-1990s to 2003, despite rising prices during the period. However, starts took off following government initiatives and averaged around 400,000 annually between 2003 and 2007; 30% higher than the average of the previous three years (Figure 4.3). By 2007 building was at a scale not seen since the early 1980s. Since then starts have declined by a quarter but still remain high in relation to most of the rest of Europe. For example, the level of building was almost twice as high as in the UK prior to the economic crisis and now it is over three times higher. Even so, a notable decline is taking place with starts 17% down in October 2009 on the year before[11].

Figure 4.3: Housing starts, 2005–2008

Source: INSEE

[6] *INSEE.*
[7] *Housing Ministry.*
[8] *Aide personalisée au logement.*
[9] *Allocation de logement à caractère familial.*
[10] *Allocation de logement à caractère social.*
[11] *Housing Ministry.*

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The surge in housebuilding after 2003 was particularly marked with regard to the building of blocks of apartments, both in the private sector and especially for much revived social housebuilding. Previously, the output of apartments had actually fallen from mid-1990s levels, so the turnaround was all the more noticeable. This change in the composition of output reflected public intervention rather than market forces: particularly government social housing initiatives and affordable housing programmes for first-time buyers and other purchasers. However, in total, more single-family houses continued to be built than apartments and they have held up better in the downturn. The share of houses peaked at 64% in 2000 but is now around 57%. The resilience of houses in new building reflects the growth of owner occupation; general demand for higher space standards; and the suburbanised nature of modern French society.

Infrastructure improvements have played a part in encouraging the outward movement of populations. Fast train (TGV) routes out of Paris, for example, have stimulated housing growth in a wide array of cities and towns with improved journey times to central Paris. However, these more far flung commuting areas are now experiencing weaker housing markets, with starts falling faster in them, because purchasers are less willing to travel when housing availability and affordability have both improved closer to Paris.

private affordable rental housing under the rubrics 'Robien' and 'Borloo'; named such after previous and current housing ministers. Subsidies and tax breaks are available across a wide range of localities, with a variety of caps and incentives, but recently emphasis has been directed more specifically to areas of housing shortage. They can be quite generous: for example, the 'new Borloo' scheme available between 2006 and the end of 2009 provided a 30% tax break on gross rental incomes. The National Housing Agency (ANAH) also provides grants for the construction and improvement of private housing, both owner occupied and rental. It has helped to finance over 50,000 new and renovated privately-owned, rent-controlled tenancies in recent years, often working in conjunction with local authorities[12]. Energy efficiency grants are also offered. ANAH has a €500 million annual budget and gave assistance to over 110,000 homes in 2008.

Social housebuilding does not depend on market conditions but rather on public subsidy, agency initiative and land availability. Political pressure has been strong to achieve extra housing output in this sector. In fact, it may well be the case over the next few years that social housing will be the most dynamic housing sector in the absence of a marked revival in the market sector.

There are several ways in which houses are built. A common means is when prospective homeowners commission dwellings to be built on plots they have recently purchased or already own. As a result, large-scale developers have a much smaller market share than in countries like Britain, Ireland and Spain.

Time-specific subsidy schemes have existed for a number of years for private investors to encourage provision of more

The government's half a million homes a year target has never been fully achieved and the gap between it and actual building rates is even larger because of the housing market slowdown. In practice, the target has always been an optimistic one, above the probable maximum absorption capacity of a predominantly market-based housing system. Vacancy rates have been rising and a growing supply overhang may slow market recovery in both the owner and renter sectors of the market.

[12] *Housing Ministry*

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Macroeconomic influences

Economic growth prior to 2008 was good, with the economy growing at around its potential rate for a number of years. However, growth faltered in 2008, due to the deteriorating global situation, and by 2009 the economy was in sharp recession with GDP falling by 2.3%[13]. Fiscal stimuli and the existence of significant automatic stabilisers helped to weaken the extent and duration of the decline and the economy is expected to grow weakly over the next two years. Excess capacity is likely to keep inflation very low for some time to come. This will affect the real level of mortgage interest rates, offsetting some of the falls in nominal interest rates, and may depress housing market activity as a result.

Job creation is weak, while unemployment, already stubbornly high, is worsening and will probably rise to 10% over the next couple of years. The overall share of people of working age in work is one of the lowest of the advanced economies with older and less skilled people most often not in work. International agencies have argued that there is a need to free up the labour market to increase the long-term growth potential of the economy.

The state plays a large role in economic activity. Public expenditure at 54% of national income in 2005 is one of the highest in the EU. The fiscal deficit has risen sharply in the past couple of years with the recession and government stabilisation polices. The deficit is expected to remain around 8% and will put pressure on the fiscal programmes that play such an important role in the French housing market, both in terms of current stimulus measures and as longer-term features of a market in which there is a high degree of intervention through a wide range of policies.

One longer term fiscal concern is the costs of pensions on public expenditure. The impact will create the need for structural reforms as the retired begin to form a larger share of the population. Some of those structural reforms and cutbacks may well fall on state programmes related to housing.

The economy is likely to recover in 2010, but the negative experience of 2008 and its continuation into 2009 is likely to continue to weaken consumer sentiment with respect to housing. Housebuilding is still relatively high but may decline in the current economic climate.

Mortgage market

The French mortgage market differs in a number of respects from those in other countries, because of the frequently interlinked nature of state-schemes with private savings and lending activities. There are a variety of products and packages and a significant proportion of them include subsidised savings schemes, like the Plan d'épargne-logement, and subsidised housing loans. Most mortgages (over 90%) are taken out on a fixed interest basis with an average term of 25 years.

Contractual saving schemes, especially the Plan d'épargne-logement, have been important traditional sources of finance for the owner occupied sector. In them, individuals agree to save a certain amount for at least four years. The interest they receive is below market rate, but it is topped with additional government subsidies. At the end of the contractual period, people can then obtain a below-market rate loan of 2.5 times the sum saved and can also use the money saved as a deposit on a home. The cap on savings is €61,200 and is €92, 000 on loans. There are around 11 million separate 'pass book' participants in the savings scheme – all members of a household may open one, regardless of age, including minors. The value of such savings was €186bn in 2008.

The share of house loans financed by these schemes has declined substantially in recent years, due to the growth of conventional mortgage products; greater competition amongst mortgage providers; the introduction of other subsidised mortgage schemes; and the expansion of more attractive savings options.

As well as conventional mortgage finance, there are loans regulated by the state, such as Prêts conventionnés (PC). Under the PC scheme, a public or private-public organisation (like the Crédit Foncier de France) is involved in mortgage contracts with private banks, enabling the overall lending rate to be priced at below market level. There are further subsidised loans, some of them directed at moderate income households, such as the PTZ mortgages considered earlier.

[13] *OCED*

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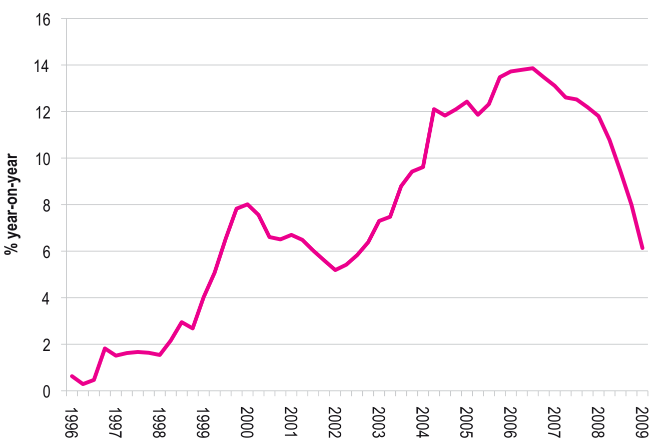

Figure 4.4: Growth of outstanding mortgage debt, 1996 –2009

Source: Bank of France

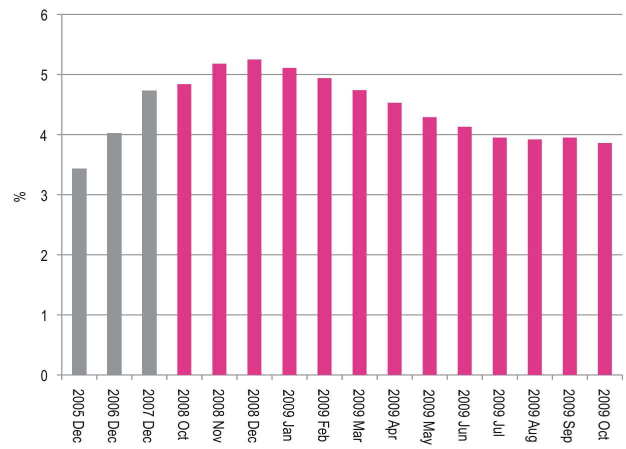

Figure 4.5: Interest rates on loans for house purchase, Dec 2005–Oct 2009 (5-10 year fixed)

Source: Bank of France

The main players in the mortgage market are the commercial banks; the mutual and co-operative banks, consisting mainly of Crédit Agricole, Crédit Mutuel and Crédit Foncier; plus other financial companies[14]. Competition increased during the boom years within the highly regulated, nationally-orientated, banking system. The outcome was an enlarged range of products and packages, narrower spreads, extended repayment times and increases in permissible loan-to-value and loan-to-income ratios. Yet, competition is still sufficiently limited to enable banks to impose risk-minimising terms; to exclude higher-risk customers; and to tighten credit conditions when market risks seem to be growing. The duality of competition and restraint, combined with the off-balance sheet nature of public mortgage loans and other related expenditure, has contributed to a low share of mortgage finance in GDP at 35%[15]. The figure of long-term loans to households, most of which will be housing related, is far higher at 76% of household disposable income in 2008. It has also risen fast in recent years, as elsewhere; being up from a half of disposable income in 1997 to three-quarters in 2008[16].

Although the government has been obliged to intervene to prop up French banks during the financial crisis, none of the major financial institutions has faced the same funding difficulties experienced by providers in some other European countries, such as the UK. In addition, few foreign players were active in the French market during the boom years, so that withdrawals from the market by them have had no appreciable effect on the availability of finance. These factors probably account for why there has not been a sharp reduction in mortgage funding. In addition, when the government injected capital into banks in 2008 it expected them to lend additional funds to house purchasers. Given the country's institutional framework, this probably had more effect than similar exhortations elsewhere.

Although housing-related debt is low by the standards of many of the other leading EU economies, it expanded significantly – doubling in nominal terms between 2002 and 2009. The biggest surge came from 2003 to 2007 and the onset of the financial crisis and then fell as the housing market began to slow (Figure 4.4).

[14]*Bank of France*
[15]*EMF*
[16]*OECD*

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Demographic influences

As with many other countries, household size has been declining over time and was an average of 2.3 persons in 2005. As a result, household numbers have been growing substantially: 2.5 times faster, in fact, than the population over the past 20 years.

The number of households is expected to increase annually by an average of between 240,000 and 260,000 from 2000 to 2020, with the fastest rates of growth in the initial years of the period[17]. Making assumptions about items such as immigration, vacancy rates, and demolitions and renewals, it is estimated that 350-400,000 new dwellings a year will be needed up to 2010 and 320-370,000 a year in the following decade. These estimates do not take account of economic factors, such as rising demand with higher standards of living or intra-regional migration to growth areas. However, neither do they take account of affordability problems, which have been significant in recent years, though they have improved over the last couple of years of crisis.

An ageing population is contributing to the rise in household numbers. The greatest increase is going to occur over the next couple of decades, with the number of those aged over 60 growing from a current 13 million to 21 million by 2035, after which time the rate of increase declines. By 2050 over a third of the population will, on current trends, be over 60. The ageing of the population has long-term implications not only for housing provision and social services, but also for pensions, taxation and economic performance and will induce major structural changes within the economy and public sector as a result, which will have long run consequences for housing taxes and subsidies, and broader housing policies.

[17] *SESP Note No 165.*

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Factfile: France

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
64.0	0.6	2.0	78

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	111	109	109	107	-
Real GDP growth %	1.9	2.4	2.3	0.3	-2.3
Growth in real private consumption %	2.5	2.6	2.4	1.0	0.6
Inflation – consumer prices % (HICP)	1.9	1.9	1.6	3.2	0.1
Labour participation rate % (15–65 yrs old in work)	-	-	69	69	70
Employment growth	-	-	1.7	1.4	-0.5
Unemployment rate %	8.9	8.8	8.0	7.4	9.1

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	5.8	6.2	5.6	-1.2	-8.7

Housing market

- Owner occupied housing: mortgage interest relief – Partial with caps.
- Capital gains exempt – yes
- Imputed rental income – not taxed
- VAT on new housing: 19.6% (5.5% social housing

- Stamp duty: 2–3%
- Property taxes as share of all taxes 2002: 7%
- Property taxes as share of GDP 2002: 3%

Taxes

Sources: Housing Statistics in the European Union 2005/6, Eurostat, OECD, INSEE.

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Overview

The housing market has not had the same degree of convulsion as has occurred in many other countries over the past couple of years. Even so, there has been some downward movement in nominal prices with the Hypoport hedonic index registering a 2.4% fall on the year in October 2009. As owner occupied housing is so fragmented in Germany, a better picture is perhaps given by the breakdown into building types in the Hypoport index: prices were down 2.8% for apartments; 4.7% for existing houses and static for new homes. (The new homes index tends to track construction costs, rather than housing market forces, as much is self-build).

These declines seem to be weighted towards the early part of 2009, with some firming of prices in the second half. New build data also suggest the worst may have occurred in the first few months of the year, with September housing permits granted 10% up on the year before. However, the business climate in residential construction was still deteriorating towards the end of 2009[1] but by nothing like the scale of most other European countries.

The world financial crisis did not pass Germany by. Fears of bank runs in autumn 2008 forced the government to offer guarantees on bank deposits. Some institutions have also had to be rescued, such as the major mortgage lender Hypo Real Estate and the major savings bank WestLB, which the government continued to have to support in 2009, including proposals to set up 'bad banks' for some of their assets[2]. Other banks have also had state injections of capital and have been put under pressure to restructure. There was better news for mortgage finance overall in 2009, as the major source of mortgage funding, the 'pfandbrief' covered bond market, was again functioning effectively after severe problems in autumn 2008.

A major benefit for the housing market is that the economy has turned around quickly after the severe drop in 2008 and early 2009, helped by fiscal stimulus programmes and lower interest rates, which kept up consumers' expenditure.

The German housing market remains oddly distinctive in its performance. Real house prices have slowly fallen on a year by year basis since the mid-1990s and no end yet seems in sight to this remarkable trend. Germany completely missed out on the long housing market boom of the late 1990s and 2000s experienced by most other countries (with Japan being the other major exception). This situation has led to some starkly different trends. German house price to income ratios have fallen by almost a third since the early 1990s and the price to rent ratio has also fallen significantly over time, as rents have tended to keep up their real levels and even rise. Obviously, these observations are at the national level and partly (though only partly) affected by experience in the new Länder. Some cities, like Munich, have experienced more buoyant situations but nothing on the scale of other major European cities.

With long-term falling house prices, it is unsurprising that there has not been a rush towards owner occupation. In addition, long-term tax and subsidy changes have depressed both investment and owner occupied housing demand. Expansion of owner occupation in a country with a majority of renters is also likely to remain a gradual process at best, though once again an incoming government has pledged to expand the tenure. The most recent official survey showed the homeownership rate remaining stable: having dropped slightly from 43% in 2002 to 42% in 2006.

Given the state of the economy and relatively plentiful housing supply, except in a few city regions, the prognosis remains for only limited house price change over the next few years. Previous experience and the current economic climate suggest that low interest rates, for as long as they last, and moderate economic expansion are unlikely to have much effect in stimulating housing demand in the near future.

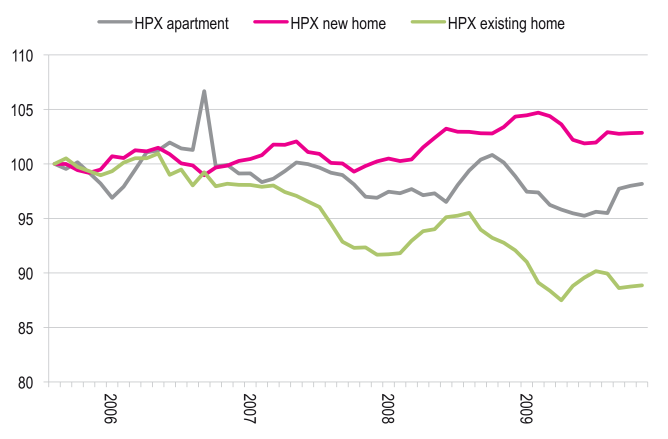

Figure 5.1: Changes in house prices by type, 2005–2009 (Aug 2005=100)

Source: Hypoport

[1] *Ifo Konjunkturperspektiven 11/2009.*
[2] *Financial Times 29.9.09 & 24.9.09.*

Recent performance has been influenced by three factors distinguishing the housing market from those in many other European countries. The first is the usually large role played by renting, with owner occupation the minority tenure. Secondly, new supply seems elastic and plentiful by European standards. Finally, the country's mortgage market has not been subject to any significant structural or competitive changes in recent years and borrowing terms were not loosened much and so the credit surges seen elsewhere did not occur.

Though past housebuilding rates have been declining almost continuously from high mid-1990s levels and now stand at around a third of that peak, they are not expected to grow much over the next few years because of the relatively quiescent state of the housing market and poor demographics.

Despite weak house prices and rents for some time, housing consumption costs have still risen. Official surveys suggest that in 2006 almost a quarter of household expenditure went on housing, compared to only a fifth in 1991. Most of the rise in the share occurred in the early years of the period up to 1995, since when housing costs have mainly grown proportionately to incomes. But, the fact that 25% of incomes are spent on housing does not suggest that relative housing costs are much out of line with elsewhere in the EU. This should be borne in mind when considering future house price changes. Because housing costs are already relatively high, the scope for 'catch-up' in German property prices seems limited.

Important causes of housing cost increases have been ancillary expenses such as water, heating and electricity charges; plus improved housing standards, such as higher living space per person, better amenities, etc.

Homeownership

The country has the highest rental share in the EU; a proportion only surpassed by Switzerland in Europe as a whole. The owner share is 11% higher in the old Federal Republic area than it is in the East (Table 5.1)[3].

Private renting is around the same size as owner occupation, by far the highest share in the EU. Social housing is now only 6% of the stock and is declining gradually through estate transfers and sales and as debt is paid off. Germany has a unique time-dependent definition of social housing, because after subsidised loans are paid off housing is no longer classified as being social. There is also a co-operative rental sector, divided roughly 40-60 between East and West, which accounts for another 6% of the stock.

The share of owner occupation varies considerably across the country. Broadly, the north and east have lower owner occupation rates than the south and west (Table 5.1). The traditional politics of local government in Hamburg and Berlin, with strong traditions of social housing and, in the case of Hamburg, public land acquisition and development mean that they are predominantly renter cities with only 20% and 14% of homeownership respectively.

	2006	Change in % share 2002-06
Saarland	55	-2.0
Rheinland-Pfalz	54	-1.4
Niedersachsen	49	-2.0
Baden-Württemberg	49	-0.2
Bayern	46	-2.5
Schleswig-Holstein	47	-2.3
Hessen	44	-0.4
Former Federal Republic	45	0.0
Germany	42	-1.0
Thüringen	41	-1.2
Bremen	35	0.3
Nordrhein-Westfalen	39	-0.3
Sachsen-Anhalt	38	-1.7
Brandenburg	40	-0.2
Mecklenburg-Vorpommern	33	-2.7
New Länder	31	-3.6
Sachsen	30	-1.5
Hamburg	20	-1.7
Berlin	14	1.4

Table 5.1: Owner occupied shares, national and regional

Source: Federal Statistical Office

[3]*Federal Statistical Office.*

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The largest decline in homeownership between 2002 and 2006 occurred in the new Länder. This was the region where house prices had fallen the most, making homeownership an unattractive prospect. Interestingly, many of the Länder with the highest owner shares actually experienced the greatest falls in percentage shares in recent years. Economic factors, notably the expected returns from owning, clearly seem to be important influences on tenure choice, as successive international studies have shown.

There are social distinctions in tenure choice. Only a quarter of single person households are owner occupiers, whereas 56% of households containing more than three people live in the tenure. A half of those aged over 60 are homeowners, as are more than two-thirds of those with net monthly household incomes at or above €3,200. In summary, homeownership is associated with 'large property, later in life, families with children, better-off, suburban or rural' types of housing. So, it is misleading to classify Germany simply as a nation of renters. Moreover, as elsewhere, owning their own home is often something to which many households aspire, particularly if they have, or aim to have, children and would like to be outside of the urban cores and live in a single-family dwelling. The demographic structure, however, is biased towards small-sized households, which encourages renting.

Around 70% of households consist of only 1 or 2 persons and the share of small households will continue to grow as the population ages. In Berlin, currently half of all households consist of single people, while in Munich the figure is 46%. In this context, it is unsurprising that the country has one of the lowest average numbers of people per dwelling in Europe at 2.2. Average household size is even less in rental accommodation, because singles and couples are concentrated there.

Only 28% of the stock consists of single-family structures (terraced, semi- and detached houses), which is low by north west European standards. Most apartments are in low rise, rather than multi-storey buildings but densities are typically high all the same. Apartments in such built forms are relatively easy to manage for large and small landlords alike, whereas owner occupation is more generally associated with single-family housing. Therefore, the built form of Germany's housing stock reflects, and has been influenced by, the structure of household types and high share of renting in the country.

Nevertheless, the greatest demand pressure is currently for single-family homes, partly because of their relatively small presence in the stock and also because of the desire of many households for more living space as their incomes rise. This demand also translates into a preference for owner occupation, as described above. Single-family homes represent the most common type of newly built dwellings and are typically in the shortest supply in the economically strongest areas.

Local housing shortages are more often than not associated with specific housing types, locations and qualities rather than with a general lack of housing. One sort of housing, such as small, old-style, poorly located apartments, can easily be in excess supply while another is in chronic shortage, particularly single-family housing in good locations. The existence of such housing sub-markets and the spread-out urban geography of the country can make reliance on aggregate average housing indicators misleading for an understanding of real housing experiences.

Thin and specific markets hinder clear consumer understandings of relative market prices and they raise home search costs which dissuades potential house purchasers from making market transactions. At a more aggregate level, price information is harder to acquire in such market contexts and is of variable quality, although a number of new sources of house price information have emerged in recent years. The situation is made worse because of an absence of price information from the major mortgage providers and property registries, though the Association of German Mortgage Banks has started to publish a quality-adjusted house price index.

The nature of German housing and mortgage markets creates difficulties for many households wishing to make the transition from renting an apartment to single-family housing and owner occupation. The relative cost of single-family housing is high. With low maximum loan-to-value ratios, the cost of entry to homeownership is insuperable for many households, particularly younger ones. Long savings periods and help from families are necessary for those wishing to buy. When contemplating purchasing, the range of choice is typically less than in countries with bigger homeownership markets. It is often difficult to find appropriate, readily available properties, because there are relatively few transactions in local homeowner markets. Agent fees and other transactions costs are high, which further discourages high frequency trading. This lack of choice in the existing housing stock, in turn, means that potential homeowners typically have to purchase new properties, often on sites available only in far flung locations where land is designated for such projects in local plans. Local new build markets are themselves often limited in scope and involve considerable consumer effort. The small scale of the new owner market discourages mass-market homebuilders, and a preference of existing types of purchaser is often for 'self-build', individualised homes. Altogether, the benefits of mass markets common in countries with high homeownership shares is absent in Germany.

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To an extent, the current low ownership rate is due to long-past housing policies and, also, to more recent subsidy and tax break policies. Many housing policies and subsidies operate at the Länder level and vary substantially between them, so it is difficult to give a precise overall picture of tenure policy biases and how they have changed. Nonetheless, housing politics in general in the 1950s and 1960s favoured rental building in both the social and private sectors, especially in certain urban regions in the West and throughout the old East. Renovation programmes after the 1970s continued that bias.

Tax-wise, there is no mortgage interest tax relief but until recently newly built, single-family owner occupied dwellings benefitted from a specific tax break known as "Eigenheimzulage", estimated to cost €7.5 billion in 2004[4]. The cost was also rising because, from 2004, existing dwellings were brought into the scheme. Then, this tax break was fully withdrawn in 2006.

Quite what the structure of future tenure relationships will be remains to be seen over the next few years. When the long-run fall in house prices finally ends and consumers begin to expect that housing is once more as good an investment as other assets, the expectation must be that homeownership will grow at the expense of renting, because the fiscal benefits previously given to landlords have fallen the most. Yet, given the extent of security of tenure regulations, it will be a long time before landlords could profitably unwind their investment positions, even if they wanted to. There are still also many institutional and fiscal biases in the housing system, many of them propagated at the Länder level, which influence consumer housing choices and housing supply.

Tenure-specific subsidies and tax breaks still exist. For example, general capital gains taxation has been raised to 25% but owner occupied dwellings are exempt from the tax – not that that matters much in the current price environment. Tax breaks can also be derived by using specific craft workers in building work.

Some legislative changes have improved the attractiveness of homeownership. In 2007, a new condominium act was passed, which should encourage apartment purchase. The law now permits 75% majority decision-making in building management in place of the previous need for unanimity, which makes repairs and renovations far easier to organise. Moreover, individual liability for common debts is now limited to a proportional burden only and operating expenses can be more fairly apportioned between households. Disputes are easier and cheaper to refer to the courts as well.

Currently, around 40% of total household wealth is in housing, either via owner occupation or residential investment. This proportion is less than in many higher owner occupation share countries, especially as many Germans rely heavily on state pensions for their retirement income needs and so do not have significant pension assets in their wealth portfolios. Recent government policy is ostensibly simultaneously trying to encourage greater reliance on private pensions and owner occupation. The latter has a pension link on the grounds that homeowners have smaller housing outgoings in retirement than do renters.

A new state-sponsored pension scheme (the "Riester pension") has been in existence since 2002. Its aim is to increase personal pension provision and it is being utilised to encourage access to owner occupation as well. Between €10,000 and €50,000 from a person's accumulated funds can be used to build or purchase owner occupied housing located within Germany. The borrowed amounts must be repaid back into people's pension funds prior to their retirement and the properties purchased must be occupied by them during their retirement. The feasibility of such a scheme shows the low level of mobility currently existing within German owner occupation.

Many new owner occupiers organise the building of their own home on a plot they purchase – or, more precisely, arrange for an architect or building company to organise its construction. They then live in that dwelling for many years. This practice, and the age and social characteristics of most owners, means that many homeowners do not move in a sequence of stages on a life-cycle housing ladder, as is common in countries such as the UK and USA. Moves earlier in a person's life-cycle occur within the rented sector and mobility is quite high within that tenure because of the low transactions costs of moving and the age profile of tenants. Once the move is made into owner occupation that home then tends to be the one in which a person lives for the rest of their life.

As noted earlier, housing policy is mainly a regional rather than a national matter. This is said to be one reason why housing statistics in Germany are limited. The regional Länder and local authorities have responsibility for housing and land-use policy and, as a result, can influence the local mix of housing tenures. Their powers are exerted in a variety of ways: through programmes related to housing renovation and urban renewal; housing subsidies; mechanisms for residential development land control; land ownership; via relationships with social housing institutions and with state-owned and regionally based co-operative savings and mortgage banks.

[4] *OECD Country Report, 2004.*

Two supply-side constraints in particular influence the expansion of owner occupation. Both arise because of regional and local government actions.

1. *Land supply constraints.* There are sometimes difficulties in obtaining appropriate land supply because of regional or local government reluctance to allocate land in land-use plans. In areas of high demand, for example, there are general planning constraints on suburban expansion, because of the general policy preferences of regional planning authorities on sustaining extensive green space in the more urbanised regions for recreational and environmental reasons.

   Historically, planning constraints have tended to be temporal in the German system. The planning system is hesitant in the face of sudden increases in housing demand but it may encourage over-investment in particular housing types, once new land-use plans are put in place. This is partly because plan formation tends to involve extensive negotiation between a wide variety of local agencies and subsidy commitments by some levels of government in order to achieve desired planning outcomes.

   This type of regional and local public policy framework helps to explain the belated surge in housing investment in the 1990s, some years after the initial post-reunification demand impetus arose. Similarly, the subsequent slow reaction to the fall off in housing demand from the mid-1990s may have had a planning element to it, because town expansion and renewal schemes were already in place and were difficult to turn off once in motion.

   Some local authorities are hesitant to sanction land release for owner occupation because they have to bear the full infrastructure costs associated with such suburban expansion yet face an uncertain, but lengthy, period before receiving revenue receipts from property taxes and state subventions as a consequence of those investments.

2. *Fixity in the rental stock.* Another frequent supply-side constraint is associated with regional and local level policies that hamper the transfer of rental properties into owner occupation or into the ownership of landlords that are more strongly market driven. This has weakened in recent years with respect to certain large scale transfers. Even so, the security of tenure offered to existing tenants, under general federal enabling and Länder specific laws and policies, frequently gives landlords little opportunity to sell out. Tenant associations are important lobbyists in local politics in a country where the majority of voters are themselves tenants. Generally, they are resistant to change.

A general political economy point perhaps needs to be made. In owner occupier dominant countries like the USA and UK, it is often argued that politicians favour owner occupation because they are chasing the marginal votes necessary to win office from homeowner households. By contrast in a country where private renting predominates, like Germany, the housing concerns of greatest interest to politicians wanting to be re-elected are more likely to be related to renting. Perceived threats to the status quo for tenants in private rental housing in Germany elicit media coverage and political responses that would be regarded as remarkable in high owner occupation countries. The judiciary are also more than likely than not to see the tenant as the underdog when interpreting evidence in any dispute with a landlord. Courts are loath to evict, for instance. Overall, the general institutional framework is more tenant than homeowner friendly.

Rental Housing

Private renting

According to official surveys, the majority of private rental dwellings, around 10 million of them, are owned by small landlords and are concentrated in the West. A further 2.6 million are owned by housing companies throughout the country, and a mix of institutions own the rest (about 1.5 million dwellings) – and they include financial institutions, real estate companies and non-profit organisations, amongst others. So, overall, around 30% of the private rental stock is owned and managed by professional firms and the rest is run by small landlords.

The scale of small-landlordism is unusual in Europe and has been sustained by attractive tax deductions. Tax breaks also probably account for the remarkably large number of lodgers recorded as living within owner occupied dwellings. Almost a quarter (23%) of owner occupied dwellings are said to contain lodgers, despite the fact that the more affluent parts of the population live in the tenure – a unique international practice. This statistical artefact helps to depress the apparent overall size of the owner occupied sector by bolstering the apparent number of tenants by 3.4 million households.

Rents are regulated both by broad federal rules and also by the policies of the 16 regional Länder in co-operation with municipalities, each of which has specific detailed rules that change periodically, creating a complex picture overall. The broad principle is said to be one of ‘softening’ of market rental movements, so most commentators conclude that rents follow market principles with a long lag[5]. However, there are insufficient studies to verify this claim accurately.

[5]*This is argued, for example, in Structural Factors in the EU Housing Markets, ECB, 2003.*

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Rents are freely negotiated at the time when a household rents a dwelling. After that, however, rent controls apply. They may be linked to inflation or to rent levels in comparable dwellings, which are determined by the sheer weight of existing tenancies rather than by the relatively small number of current market transactions. If a dwelling's rent is less than in comparable ones, any increase is smoothed because it can only be implemented up to a maximum of 20% extra on the rent for three years. This means that overall rent levels lag far behind implicit current market rents when there is a sudden increase in demand or inflation. Nevertheless, rent controls have not been a political issue for some years now, because there is a general situation of oversupply in many localities and so market rents are either only rising gradually, or have actually fallen.

Tenants have security of tenure as long as they pay the rent and behave well, except in the rare occasions when a member of the landlord's family needs the accommodation or when the building is going to be replaced.

The IPD German residential index, based on about 2,500 properties, showed a return of 4.4% in 2008. This was made up of a 3.7% income return and 0.6% capital growth.

Social renting

Social housing means something different from elsewhere in Europe, as it does not refer to a specific set of non-profit housing providers with special relationships to central and local government, but rather to specific subsidy systems. The social housing subsidy system, moreover, can be used by private landlords and for low cost owner occupation. Dwellings only remain in the socially rented sector for as long as they receive interest rate subsidies, plus around ten additional years – which typically comes to approximately 40 years altogether.

Social housing institutions are in long-term decline following a switch in policy from supporting specific providers. Even so, many cities still have at least one publicly-owned property company providing housing[6]. These companies are organised within the Gesamtverband der Wohnungswirtschaft (GdW)[7]. Members of GdW lost the privileges of their non-profit status in the early 1990s, following a scandal surrounding the financial collapse of one of them, and are now treated as profit-making entities.

In the East, the large rental stock was in a rundown state at reunification. The programme of housing privatisation in the East has been far slower than was originally anticipated. Social housing programmes have had to deal with large numbers of poor quality and empty properties in the East, where in 2002 there were 1.3 million vacant properties. Programmes of extensive demolition and neighbourhood regeneration are in place and will continue for some time to come. Old industrial areas in the West are facing similar problems, though on a smaller scale[8].

Privatisations and sell-offs

There have been some substantial sales of rental homes in the past few years by non-profits, industrial firms with residential estates and the public sector. In general, funds aim to make returns in several ways: through renovations, sales to tenants, other disposals, managerial and financial efficiencies, and through hoped-for future rent and price rises. Some investors had over-optimistic views of the returns that could be made and naively anticipated that Germany had 'missed out' on the housing boom and so would have one soon. As result, several recent purchasers have already sold out as returns have been lower than expected and highly leveraged purchases left some of them exposed in the credit crunch.

Public sector and municipal bodies still own around 4.5 million dwellings. Some city governments are reluctant to sell social housing and other parts of the stock have limited market potential.

REITs were launched in Germany following legislation in 2007 but housing has generally been excluded from REIT activities. They are not allowed to acquire pure housing investments as part of their real estate portfolios and the residential element of mixed-use schemes has to be less than 50%. The no-housing stipulation was put into the legislation following widespread negative political reaction to the consequences of introducing more market-oriented owners into the rental market. It was widely believed that if REITs became housing landlords they would operate less in the interests of tenants than occurs with existing institutional arrangements. Such a belief highlights the practical limits of market forces in German rental housing. The world financial crisis meant that 2008 was an unfortunate year to set up such vehicles and only two REITs were set up. However, more are expected to join them as financial markets improve.

[6]In Berlin, for example, there are about ten public housing companies.
[7]The organization of the private housing companies is the Bundesverband Freier Wohnungsunternehme e.V., (BFW). However many companies are members of both organisations.
[8]Wohnungswirtschaftliche Daten und Trends 2009/2010, GdW.

Housebuilding

Housing completions fell by 16% between 2007 and 2008 but permits data suggested that the worst was over by spring 2009, with permits up by 10% year-on-year by September[9]. The overall fall in housing investment expenditure was expected to be 4%, so that the economic slowdown has taken its toll of housebuilding.

There has been a long, slow decline in housebuilding since the mid-1990s boom, so that output is now less than a third of that peak period (Figure 5.2). There have been some fluctuations along the way, some of them policy-induced. For example, 2007 was the year that owner purchase subsidies were abolished and VAT in general was increased by 3% to 19%, which is significant for housing because the standard rate of VAT is charged on new building. As well as raising the cost of new housing, these changes were announced a long time in advance. Unsurprisingly, many people brought forward their housing plans to beat the tax and subsidy changes, after which building fell and then continued to do so with the onset of the economic crisis.

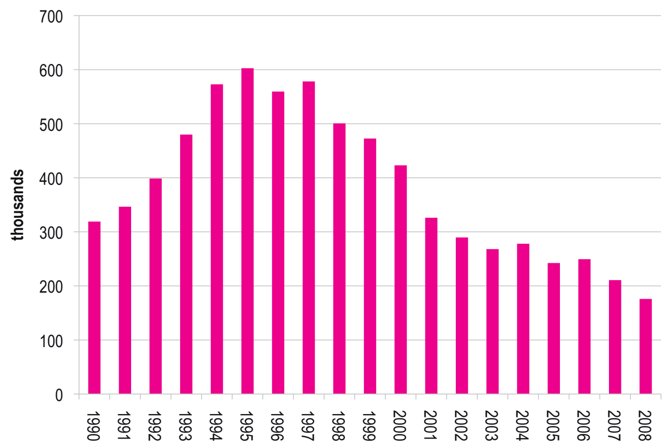

Figure 5.2: Housing completions, 1990–2008

Source: Federal Statistical Office

The building boom that occurred in the mid-1990s was stimulated by the post-reunification experience. Policy makers over-reacted to temporary accommodation shortages and new housing production subsidies and tax breaks were rushed through. In addition, the government provided low interest loans for housing investment and further incentives were offered in the East under the Promotional Area Act. It transpired that the scale of the building boom was out of all proportion to long-term housing demand, so by the mid-to-late 1990s signs of severe over-building in many localities were apparent. This encouraged a downswing in the housing market and a rising vacancy rate, as excess supply came on stream and was only slowly absorbed.

The overall aggregate effect of the 1990s building boom was substantial. Altogether 4.4 million dwellings were completed between 1991 and 1999 – with most of the units being small to moderate sized apartments – and the overall housing stock rose by a substantial 11%. The scale of the new supply created during that period has been sufficient to accommodate demand in many localities for a long time afterwards. It may now be the case that housebuilding will once more begin to rise; though a revival has been long anticipated. The weakness of economic growth expected in 2010 does not suggest the moment is still quite there.

[9]Federal Statistical Office.

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Macroeconomic influences

Activity in 2008 slowed rapidly because of weak private consumption and poor export performance due to the global slowing, and the situation worsened in the first quarter of 2009. But the economy responded to government stimulus measures by the second quarter and continued to improve through the year, although a fall in GDP of almost 5% was recorded for 2009 as a whole. Growth is expected to be sluggish in 2010 as well.

Inflation was running at over 2.5% in 2008. However, falling commodity prices and the recession curtailed inflationary pressures sharply in 2009 and by September prices were 0.3% down on the year[10].

Unemployment was 11% on an internationally comparable basis in 2004 and remained high, although it had fallen to 7% in 2008. The recession has pushed it up once again and it may well reach 10% over the next couple of years, according to OECD forecasts. Unemployment is concentrated in the East and in the older industrial areas of the West. One structural problem affecting the economy is the remaining huge economic gap between East and West. The process of adjustment in the East, and with it the evolution of a more typical housing structure, still has a long way to go.

Mortgage market influences

The mortgage market relies on finance provided by one or other of the three pillars of the financial system: the commercial banks, the public savings banks, and the co-operative sector. Via each route, a prospective purchaser may raise finance through loan packages. On offer are variable rate loans but more usual are mortgages with a rate fixed of five years or more – 10 years is the most common. There are prepayment penalties during the period that the rate is fixed. Around 80% of the housing loans held by banks of all types were long-term fixed interest mortgage ones. Mortgages secured on housing may also be used for other purposes and are often a source of credit for the small business sector.

The country has a unique financial system and a large number of banks, with two-thirds of the total credit institutions existing in the euro area as a whole. Mortgage banks traditionally had the sole right to issue mortgage bonds (Pfandbriefe) in the capital market. Their bonds are covered by the real estate mortgages (and other assets) they hold on their balance sheets in a matching process. A legal requirement is that these mortgages have first call on properties. High prepayment penalties and low mortgage default rates give confidence to bond investors with regard to the strength of the mortgage banks and their regulatory regime; especially a 60% limit on loan-to-value ratios and existence of strong capital bases and/or state guarantees of the issuing banks.

As elsewhere, institutions lending mortgages screen customers for their ability to repay a mortgage, and loans can be advanced up to 100% of a dwelling's value. However, such high loan-to-value ratios are uncommon. Loan offers may consist of a mortgage bond loan which, because of its security, commands a good interest rate and other elements with different repayment terms, degrees of security and interest costs.

The existence of the Pfandbrief core to housing loan packages may confuse those not used to the German financial system into believing that loan-to-value ratios for residential loans are capped at a 60% ratio, which is not the case. In June 2009, 17% of new housing loans on aggregate were not mortgages, and a similar ratio has prevailed in the past few years, pushing average overall LTVs towards the 80% level[11]. Nevertheless, the typical 80% LTV ratio is less than exists in some other countries, especially for first-time buyers, and indicates that credit availability is more strictly rationed in Germany. It should also be remembered that many loans are advanced to housing investors as well as homeowners in a country with a large private rental sector. The Pfandbrief market, set up in the nineteenth century, has formed a model for others elsewhere in Europe and has fundamentally influenced the structure of mortgage lending in Germany. When combined with the three separate pillars of the German financial system – the private, state and co-operative – the nature of German mortgage offers begins to make sense to the uninitiated. For decades, the main mortgage banks have been subsidiaries of the universal banking institutions existing in all three of the financial pillars. Within the universal bank framework, a variety of mortgage packages are sold to owner occupiers and landlords structured around the bond-funded mortgage loan.

[10] *Bundesbank Monthly Bulletin.*
[11] *Bundesbank.*

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Consolidation within the banking sector is effectively limited to changes within each ownership form, because of the distinctive ownership structures of the co-operative and state-owned banking sectors. Some state banks have merged in recent years and some have got into difficulties through over-ambitious lending and investment strategies and are currently looking for new owners, most notably WestLB. There are few pressures for organisational restructuring, so a widely fragmented ownership structure remains. This limits the opportunities for scale-economies and innovations in the mortgage industry and reduces the opportunities to narrow spreads and cheapen borrowing costs for consumers. One of the major changes of recent years has been a lengthening of the potential repayment period, which now is possible for up to 30 years.

The mortgage banks' monopoly access to covered bonds was abolished in 2005, following pressure from the European Commission which was worried about the competitive effect of the public guarantees previously given to state-owned mortgage banks. Now any licensed institution has access to the Pfandbrief market. At the same time, regulatory and capital adequacy criteria have been strengthened to ensure that all licensed participants remain solvent in the face of financial shocks and so cannot threaten the virtually risk-free perception of the bond market with investors.

Housing loans from building and loan associations, Bausparkassen, are common adds-on to bond funded mortgages. These institutions organise housing savings and loan schemes, whereby households commit to long-term savings contracts offering a below market interest rate in exchange for a similar termed loan advanced when required, providing that agreed savings thresholds have been reached. There were €120bn of outstanding deposits under savings and loans contracts in August 2009 and €30bn of loans under savings and loans contracts plus a further €70bn of interim and bridging loans - similar figures to those in 2008[12]. This is a relatively small but still significant part of housing finance activity. As with mortgage banks, most Bausparkassen are now parts of universal banks and their activities contribute to the mix of housing finance packages on offer.

Competition in the mortgage market is structured by some basic and unchanging procedures. Those rules not only militate against large loan-to-value ratios but also against a systemic bias towards generous valuations of properties, as seen in some other countries in recent years, because such a trend might undermine the Pfandbrief market. The German home loan system consequently has built-in conservative lending criteria that do not exist in many other countries' mortgage systems, which rely more on the perceived viability of mortgage issuers and their ability to limit the scale and consequences of defaults.

Mortgage finance volumes grew during the expansionary 1990s but in the 2000s the increases were modest (Figure 5.3). There was some reduction in the volume of outstanding mortgages since the start of the world financial crisis and for most of 2009. But the decline has not been as great as in some other crisis-hit European countries, despite a temporary seizing up of the Pfandbief market in 2008-2009. In q3 2009 outstanding housing loans were only 1% down on the two earlier quarters[13].

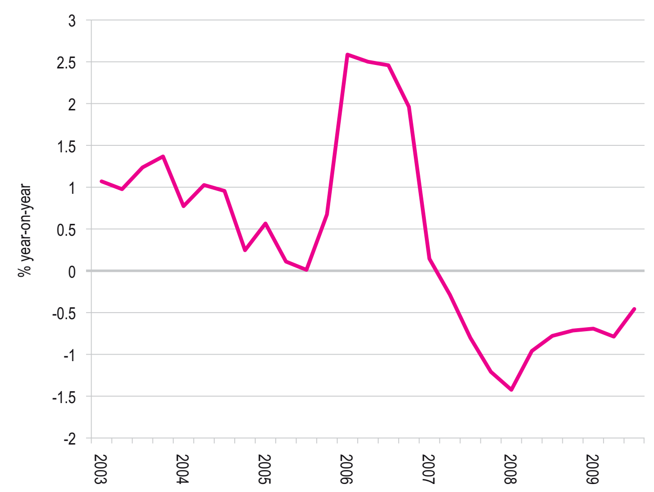

Figure 5.3: Housing loans, 2003–2009

Source: Bundesbank

[12] *Bundesbank.*
[13] *Bundesbank.*

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Home loan interest rates peaked at the end of 2008 and were down by 130 basis points by autumn 2009 (Figure 5.4). This fall would have helped to offset the negative consequences of the recession-hit economy on housing demand.

A significant part of mortgage borrowing is used to finance rental housing, which has been an important factor in determining mortgage market behaviour, because many rental investors have experienced some softening of rents and falling capital values in recent years.

The depressed state of many local rental markets and the limited amount of social housebuilding in recent years have helped to flatten off mortgage growth – as these factors have probably led to more mortgage debt being paid off in those sectors than taken out. Owner occupied housing's share of the mortgage market is also greater than implied by its tenure share, because it tends to be associated with more expensive dwellings and larger per unit borrowings.

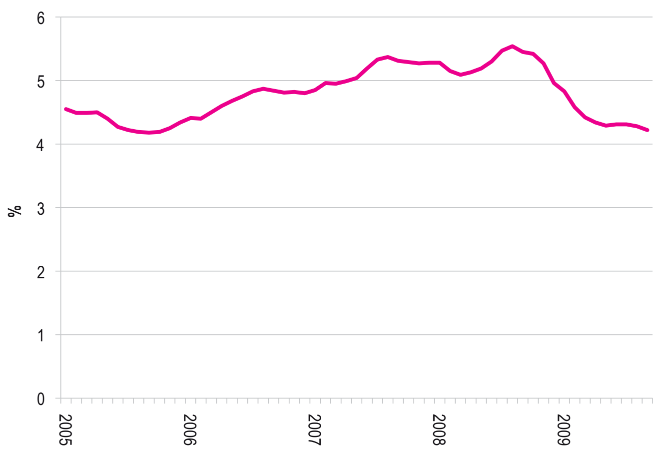
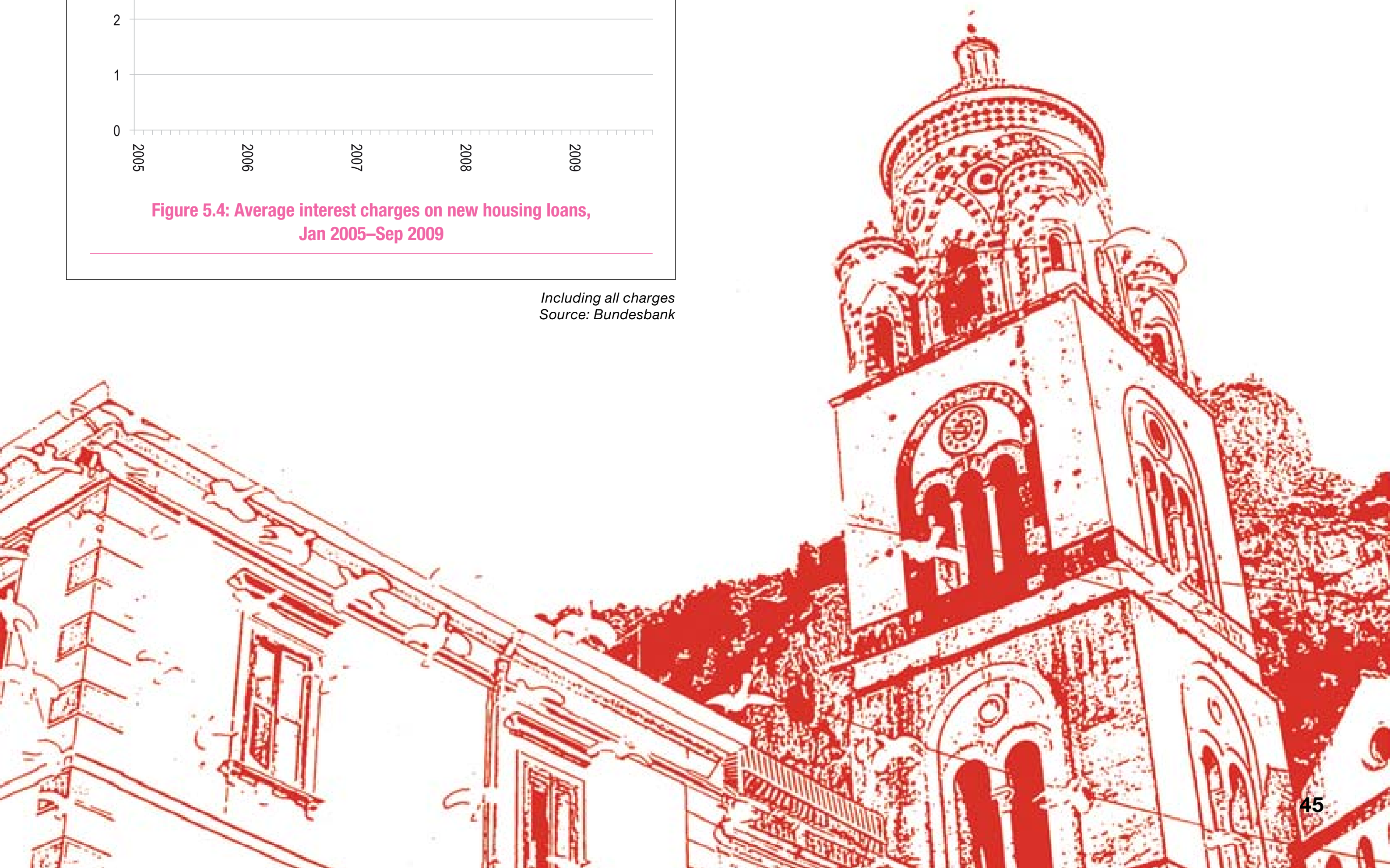


Figure 5.4: Average interest charges on new housing loans, Jan 2005–Sep 2009

Including all charges
Source: Bundesbank



Demographic influences

The population is falling slightly at present but is forecast to decline significantly. Recent estimates suggest that, at current birth rates, immigration levels and probable increases in life expectancy, the population will drop by 9 million to 74 million by 2050, more than a 10% decline[14]. However, population forecasting is an inexact exercise based on assumptions that may not hold, especially given the potential scale of future population movements within Europe, the geographic centrality of the country and the problems that will arise with an ageing society.

On current projections, a substantial 37% of Germans will be over the current retirement age of 60 by 2050 and ageing will have significant demographic effects in just a few years' time (Table 5.2). The current old-age ratio (retirees to people of working age) is 44 (i.e. 44 people over 60 for every 100 aged between 20 and 59). By 2020, this will have risen to 55 and by 2030 to a substantial 71.

An ageing society will have implications for pensions, health care and public finances and for housing. The demand for special needs accommodation for the elderly will grow exponentially; the number of single person households will rise; and the aspirations of an increasingly affluent post-60 age cohort could have a substantial impact on housing demand patterns. Housing demand will become less locationally tied to employment and more influenced by personal relationships (to family and friends) and living preferences.

The implications for the housing market are made more complex by three other important demographic factors. First, household size should continue to fall and so lead to a greater demand for dwellings than implied by population decline alone. Second, the greater the fall in the population the more likely there is to be substantial internal migration towards the economically strongest regions and the most desirable retirement locations. So, the impact of any decline in housing demand will be geographically concentrated in a number of 'problem' areas and regions. Third, it is hard to believe that the country would go through a painful process of demographic adjustment without altering rules regarding citizenship and immigration. To an extent, the rules do not even have to change as economic forces will come into play. The rise in earnings likely to come about with a declining labour force should encourage others with free access to labour markets (i.e. those from elsewhere in the EU) to move to the good German employment opportunities on offer.

Currently, the country has far more foreign nationals living in it than any other European country in absolute terms: 7.3 million compared to the next highest country, Spain, at 4 million. In part, this reflects recent immigration but also the length of time and difficulty to acquire German citizenship in comparison, say, to France and the UK, something which, incidentally, encourages the propensity to rent.

	2001	2050
Aged less than 20	21	16
Aged 60 and over	19	37
Aged 80 and over	4	12

Table 5.2: An ageing society (% of population)

Source: Federal Statistical Office

[14] *Federal Statistical Office forecasts.*

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Factfile: Germany

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
82.2	-0.1	1.4	77

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	117	116	115	116	-
Real GDP growth %	0.9	3.4	2.6	1.0	-4.9
Growth in real private consumption %	0.4	1.4	-0.3	0.2	0.8
Inflation – consumer prices % (HICP)	1.9	1.8	2.3	2.8	0.2
Labour participation rate % (15–65 yrs old in work)	-	-	80	80	81
Employment growth	-	-	1.7	1.4	-0.1
Unemployment rate %	10.5	9.8	8.3	7.3	8.7

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	-3.7	6.0	-1.4	-0.4	-1.2

Housing market

- Owner occupied housing: Mortgage interest relief – no
- Capital gains exempt – yes
- Imputed rental income – not taxed
- Stamp duty: 3.5%
- VAT on new housing: 19% (from 2007)
- Property taxes as share of all taxes 2002: 2%
- Property taxes as share of GDP 2002: 1%

Taxes

Sources: Federal Statistical Office, Eurostat, OECD.

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Overview

The housing market was pulled by a variety of distinct pressures in 2009. The first and most important, of course, was the impact of the world economic and financial crises, which hit Hungary particularly badly and led to the calling in of the IMF and the introduction of an austerity programme. The second was that, unlike many other European countries, mortgage interest rates have not fallen, rather the reverse; especially for forint denominated loans. Finally, the government announced several key housing-related subsidy cuts and tax increases several months before implementing them, which led to the bringing forward of market activity to the first half of the year. As an overall result, the first half of the year did not look too bad considering the circumstances but the second half turned out to be much worse.

Hungary's period of booming house prices was earlier and less sustained than those of most other central and eastern European countries in the 2000s. Prices did increase between 1998 and 2001, particularly in Budapest, with the greatest price growth concentrated in the new build market. But then price growth gradually petered out as vote winning subsidies were withdrawn and fiscal austerity caused a sharp reduction in economic growth.

The new FHB House Price Index shows national prices being pretty much static between 2004 and 2007 in real terms, before gradually sliding into negative territory between the beginning of 2007 and the middle of 2009, when they were 11% down on the year before in real terms (Figure 6.1). The country has been suffering from relatively high inflation in recent years, so it is particularly useful to examine real price changes.

More recent data from the agency Otthon Centrum shows sharp falls in transaction prices in the second half of 2009 once the new fiscal regime was in place. For example, family houses were down 25% from the summer by November in Budapest and 23% in the country as a whole. These data are from a smaller sample and are not quality-adjusted like the FHB ones, but indicate a sharp deterioration in the housing market. Housebuilding data from the central statistical office tell a similar depressing story.

Growth is not expected to return to the economy until 2011 and fiscal austerity will remain in place, unless the forthcoming election causes an upset. The bringing forward of housing demand through the fiscal measures of 2009 may, by inducing subsequent sharp price falls, unwittingly help to intensify negative price expectations and further prices falls in 2010.

Alternatively, prices may bounce back somewhat as the impact of them fades and activity rises again. So, the forthcoming year is one of particular uncertainty for the housing market and the economy in general.

The use of mortgages has expanded rapidly in recent years from a very low base. However, the total loan book is not much above 10% of GDP. Over the last few years, borrowing in foreign currencies has eclipsed borrowing in Hungarian forints (HUF) because of the much more attractive interest rates on offer, although it has become harder to borrow in foreign currencies since the crisis. The amount of outstanding household loans denominated in foreign currencies has now risen to over 60% of the total. This represents a significant exchange rate risk to some households' finances and to the housing market in general.

The overall high level of foreign debt had pushed the Hungarian economy to the brink of a major run on the currency in the aftermath of the Lehman Brothers collapse in 2008. However, the risk of major exchange rate convulsions declined during 2009, following support from the ECB late in 2008 and the adoption of an IMF programme.

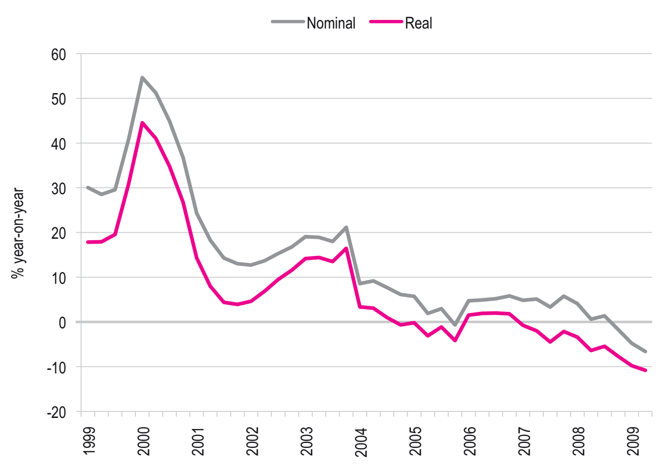

Figure 6.1: House price change, 1999–2009

Source: FHB House Price Index, KSH

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The resulting programme of higher taxes and lower subsidies has affected the housing market in several ways. In a measure announced in April 2009, the government abolished the mortgage interest subsidy scheme for those with children, with effect from 1st July. It was estimated that around a fifth of borrowers had used the facility and there was a rush to buy whilst eligibility remained[1]. Later in the year, the government announced a new scheme with effect from October of help for young people and families with children but limited to new housing. Housebuilding was hit by an increase in VAT from 20 to 25%. A property tax has been introduced, with effect from the beginning of 2010, on those worth more HUF30m: at a progressive rate of 0.25% for HUF30m; 0.35% between HUF30m and HUF50m; and 0.5% for any portion at higher values. This measure is to be based on property values formulated in a new official property value assessment, which will use average values in quite large local districts with some adjustment for detailed property amenities to create the valuation for individual properties. The tax is likely to become quickly capitalised into house prices and, so, will have a short-term, one-off depressing effect on values in consequence.

The housing system

Housing standards are relatively better than the average for central and eastern Europe (CEE), though low by western European standards in a country where the average standard of living is just under two-thirds of the EU average. There are not the absolute shortages typical of neighbouring countries, though inevitably insufficient housing exists in high demand areas, like Budapest. Nonetheless, there is a substantial quality and repair problem in the existing stock.

At 93% of the housing stock, Hungary has one of the highest private ownership rates in both the EU and the world as a whole. There is a long tradition of owner occupation. In the 1980s, it was around 65% with virtually all of the remainder rented from the state.

Rural housing has traditionally been owner occupied and so has much middle-class urban housing. All major cities have several substantial neighbourhoods of relatively high-quality, middle-to-upper income residences built in the nineteenth and early twentieth centuries and some later pre-1950s housing. More parts of the existing stock correspond consequently to middle-and-upper income group housing aspirations than is the case for some of the other countries previously within the Soviet bloc, where low historic building rates, neglect, war-damage, demolition and industrialised building left poorer housing legacies, which have been tackled to only a limited degree over the past 20 years.

Most building is for private owners. A development industry has been growing strongly in recent years, focusing on entry level accommodation, and now matches in output individual ‘organise-your-own’ (OYO) building. However, its output has declined in recent years due to relatively weak demand. In cities like Budapest, there is a lively second-hand market, especially for better-quality homes of which there are quite a number.

The existence of substantial transactions in the existing homes market and the relatively good supply of existing dwellings relative to demand have helped contribute to the lower level of price increases in the Hungarian housing market compared with those in several other CEE countries. Two-thirds of mortgage loans (and subsidies) were used to buy an existing home in 2008. So, the formal housing market is deeper and more mature than in many other parts of central and eastern Europe. As the housing market in Hungary has a broad base, the new build market does not dominate recorded transactions and price indices as it does in a number of other CEE countries.

During the era of shifting to a market-based economy in the 1990s, there was a substantial programme of selling-off state housing. This greatly increased the amount of private ownership and left only 4% of the stock in state hands. How much of the ostensible private ‘owner occupied’ stock is actually rented out in full or part is unknown, so the 90+% homeownership figure may exaggerate the true incidence of owner occupation because of the existence of unrecorded privately rented dwellings. Even so, the owner occupied rate is clearly very high.

Sales of flats have mainly been on a condominium basis. This has had consequences for the privatisation of housing. Many apartment buildings ended up as mixed tenure ones with local authorities remaining responsible for them. People on lower incomes who have remained tenants cannot afford the higher rents of improved properties. Some new owners are also reluctant to contribute to repairs and improvements. However, earlier uncertainty over the enforcement of repair obligations was resolved by a recent law making contributions to collective building repairs compulsory.

The total housing stock in 2007 consisted of 4.2 million dwellings. The average dwelling size is 75 square metres (63 in Budapest) and there are 2.4 people per dwelling. The stock is relatively old, with around a quarter built before 1945 and only a limited amount constructed since 1990. Almost 70% of the housing is single family and another quarter is in 2 to 4 storey structures, so high rise flats are far from the norm. The situation is very different in Budapest, however, where a quarter of the stock is apartment blocks of 5 storeys or more and less than a third is single-family[2].

[1] *Otthon Centrum Credit Centre.*
[2] *Central Statistics Office.*

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There are quality problems in the housing stock, although improvements are being made with demolitions of some of the worst – running at an average of 4,000 units annually – and renovations of others. A significant proportion lacks facilities, with around a quarter failing to meet the official comfort standard. Many also lack one or more basic amenities, especially in rural areas and small towns. For example, over a third of dwellings have no link to public sewerage[3].

Maintenance is also an issue. Only a quarter of dwellings require no repairs, around two-fifths need partial restoration and another fifth need full restoration. The situation is worse in Budapest, where only 10% of dwellings require no works and 38% require full restoration or demolition[4]. Many rural houses, in addition, especially those built prior to 1990, utilised poor quality building materials and no skilled building labour and can be in bad shape. The backlog requiring substantial investment is consequently huge and will take many years to work through.

Today in the larger cities, the stock is made up of four main housing types:

- Inner city multi-family buildings built at the end of the 19th century or during the inter-war years
- Single family housing in suburban and semi-urban settings
- Housing estates from the centrally planned economy era – often on a large scale – consisting of 5–10 storey buildings, built in suburban locations
- New housing built in the past 20 years, consisting of single family homes and apartments.

Most urban housebuilding took place with industrialised large panel and other concrete systems during the 1970s and 1980s, constructing standardised flats on large housing estates with around 55 square metres of living space. A fifth of the population, 2 million people, now live in such dwellings[5]. Many of these are in a poor state of repair and have bad insulation. However, not all of them are necessarily at the bottom end of the housing market in terms of relative prices. According to Otthon Centrum, better quality ones with improved insulation, energy-saving services and, most importantly, their own meters for measuring energy use may command at least the same prices as equivalent brick-built dwellings in the same neighbourhood.

The Hungarian housing market has been distinctive over the past decade for the wide range of subsidies that have been introduced and withdrawn at various times. They have been directed at the owner occupier market or parts of it, with the aim of winning votes. They include interest rate subsidies for housing-related savings deposits and for mortgages; aids to condominiums to renew common areas; grant subsidies for younger couples with children to construct, enlarge or buy homes; VAT relief for new housing; tax breaks on capital repayments; and stamp duty waivers. Complex stipulations and caps were imposed but, overall, the subsidies were generous. Ensuing public expenditure crises then subsequently led to curtailments and then new voter enticements came along. There is some hope that the high economic costs of electoral profligacy are now sufficiently recognised for this era of housing policy to be drawing to an end.

Much of the house price history of the past decade can only be explained through a tracking of changes in varying subsidy rules. The justification for most of them on economic or social terms was scant. The announcements in 2009 of subsidy and tax changes several months in advance of them happening is consequently part of a long history of political intervention into the housing market.

Another feature of the current housing situation is the low level of mobility. A typical person moves 2.7 times in their life compared to 6 or 7 times in western Europe. This is badly affecting new households and those moving for work reasons i.e. labour mobility, particularly with regard to flats. Three-quarters of new rental dwellings are built in the social sector, with around 2,000 constructed each year.

Housing transaction processes, as elsewhere in central and eastern Europe, are not as easy, certain or as cheap as they should be. In 2004, a land and property registration law was introduced which is gradually improving matters with respect to title. More market information is emerging over time.

[3]Central Statistics Office.
[4]Central Statistics Office.
[5]Ministry of Interior.

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Housebuilding

Housebuilding has been on a downward trend since the general slowing of the economy in 2004. There are two main types of developer: individuals and professional development firms, and their relative fortunes now determine housing output levels.

One sector that builds only a small amount of housing nowadays is the social sector, mainly comprising local government. Up to the 1990s, the major part of the 80-100,000 houses built annually was in the social sector. Then it virtually ceased after 1990, although there was a slight revival following the introduction of investment subsidies in the early 2000s; ones which were subsequently abolished, so that social output fell to a negligible level again (see Figure 6.2). Output was far lower in the 1990s than in the previous decade, with housebuilding numbers varying between only 20-30,000 homes a year; a quarter of the previous scale but one generally more attuned to consumer preferences.

In the 1990s, Organise-Your-Own (OYO) building came to the fore. This is undertaken by individuals managing the construction of occasionally custom-designed, but generally fairly basic, single family units on plots of land they already owned or have recently acquired.

Developers of new housing for sale are fairly recent. Only a few existed in the 1990s and they focused on the upper-end of the market. They only really took off when the state mortgage interest subsidy regime was introduced in the early 2000s. Developers' output peaked at over 18,000 units in 2005 and now represents almost a half of all building, nearly matching that of OYO (Figure 6.2). Hungary's housebuilding rates are still low by average EU standards, at 3.6 dwellings per 1000 population in 2008.

For sale output is predominantly built by large-scale firms, many of them foreign. The foreign ones have the financial muscle, the marketing credibility and the economies of scale necessary to succeed; whereas the typically smaller domestic firms are less able to cope on a sustained basis, particularly in raising credit. Hungarian firms are said to be crowded out of the most prestigious, central Budapest areas by foreign firms more able to pay for land and to persuade foreign buyers to purchase their products. Foreign firms have also moved out from central Budapest to suburban areas, to other large cities and to the Lake Balaton holiday area[6].

Typical floor areas in the new build for sale sector are small and most dwellings are aimed at the first-time buyer market. Average floor areas have been consistently falling in size since the late 1990s, as developers have switched their production strategies away from the luxury towards the middle market sector. By contrast, average floor areas are larger in the individual OYO sector and have been growing in size. The difference is due to several factors. Individual OYO construction tends to be at lower land value locations; much of this housing is single-family in nature, instead of the developer-built apartments; and their initiators are often searching for higher quality housing, rather than looking for a first step onto the housing market ladder.

Dwellings permits fell by 26% in the first nine months of 2009 and the greatest decline was in the third quarter when they were 40% down on the year before. Completions had held up but were 23% lower in q3 2009 as well. The biggest decline was in the OYO sector, with developers holding up better; possibly because they were building out already started projects[7]. Over half of all housebuilding was in the Budapest region.

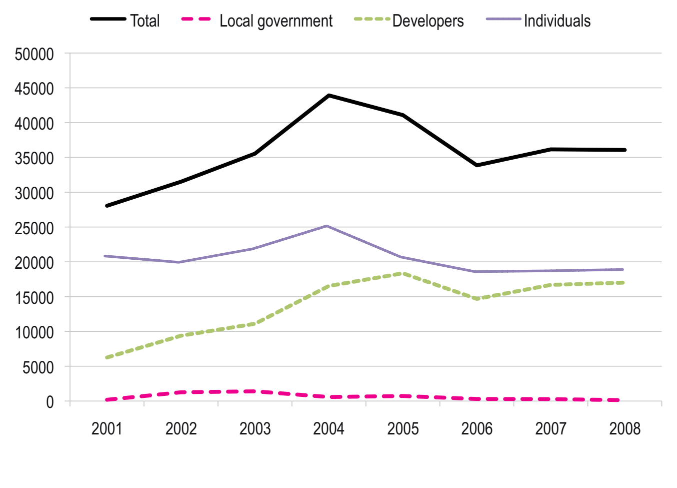

Figure 6.2: Housebuilding by type of developer, 2001–2008

Completions
Source: Central Statistics Office

[6] *Othon Centrum.*
[7] *KSH.*

CHAPTER 6: HUNGARY

Macroeconomic influences

The economy has been dragging housing demand down, as it has been for several years. Growth had been flat for some time and then the economy fell dramatically into recession in 2008 and into 2009. It contracted by almost 7% in 2009 and is likely to decline further in 2010, though cuts in interest rates may begin to revive activity.

The economy had been facing problems with a large government deficit for some years, running at over 9% of GDP in 2006 and 5% in 2007. The deficit was primarily caused by political parties propelling themselves into power through unsustainable populist fiscal measures, such as the early 2000s mortgage interest subsidies. Once in place, such measures are then politically difficult to undo. There are also chronic problems with tax collection. To make matters worse, there was an associated balance of payments deficit, although that was reduced sharply in 2009 due to the sharp squeeze on private consumption.

Government austerity packages were reinforced by the near bankruptcy of the country late in 2008, as noted earlier. These have helped to push unemployment up to 10% and it is likely to remain high for several years to come. There is unlikely to be any improvement in the percentage of the population of working age in employment, which at only 61% represents a significant loss of productive potential and is significantly lower than levels in western Europe.

Inflation has been high for some years in the overheated economy. A sharp spike of 8% was reached in 2007, partly due to the government's austerity measures and also because of imported inflation. Though moderating slightly it still is above many other European countries at present.

Over the longer-term, economic factors are likely to play a considerable role in stimulating housing demand. Income levels will rise as economic growth revives and gradually converges with that in the rest of the EU. The percentage of people of working age in work is also likely to increase significantly. When this occurs, the incomes of younger households, in particular, will be able to bear greater housing expenditure. Investment in rental dwellings should also become more attractive. The long-term prognosis for the housing market looks good, though there may well be some severe bumps along the way, especially if the economy remains prone to its political cycle.

Mortgage market influences

Up to the 1990s, mortgage debt was around 15% of GDP and most of it was used to fund social housebuilding. This finance market all but disappeared by the mid-1990s as old debts were paid off and housebuilding and associated mortgage loans sank to low levels. High mortgage interest rates then deterred new private borrowers. As recently as 2000, nominal interest rates stood at over 22% on HUF-denominated loans and they were still over 12% in 2004. In fact, it was not until 2006 that HUF-denominated interest rates fell to 10% but then they started nudging up again later in 2006 and then rose sharply during 2008 as the world financial crisis began to bite, before moderating slightly in 2009 (Figure 6.3). In real terms, they are some of the highest in Europe. Far better rates could be found via euro and Swiss franc (CHF) loans, although these have become harder to come by, and carry an exchange rate risk. Government policy has been to broadly peg the forint to the euro for some years, giving the impression of stability and low risk. However, in autumn 2008, the exchange rate deteriorated sharply. It recovered somewhat after international intervention and has remained lower in 2009 - although exchange rate risks have by no means gone away.

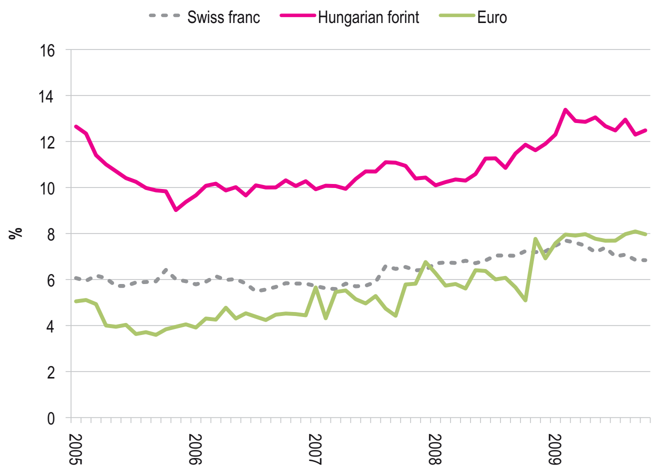

Figure 6.3: Euro, Swiss franc and HUF mortgage interest rates, Jan 2005–Oct 2009

Average annualised monthly new business
Source: Central Bank

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The use of mortgages really picked up from 2002, following the introduction of generous mortgage subsidy schemes by the then government. It has grown at a fast rate for some years, but the market overall is still small-scale by western European standards and represents only around 13% of GDP[8].

From hardly existing previously, foreign exchange mortgages had crowded HUF-denominated ones out of the new loans market by 2006. Their use continued to grow, even through the late 2008 financial crisis, before dropping slightly in the middle of 2009. By late 2009 foreign exchange borrowing represented over 60% of outstanding housing loans (Figure 6.4). The most common currency used is the Swiss franc but banks offer a wide variety of options and euro-base loans have become more popular since the financial crisis.

The threat of financial collapse and the mortgage default risk associated with a currency devaluation encouraged the government in 2009, with international support, to introduce a partial mortgage guarantee scheme for debtors whose debt-service-to-income burden increases sharply. For households whose debt-service-to-income ratio increases by at least 25%, the government offers a guarantee of 80% of the loan[9].

As well as the ability to switch currencies, mortgages can now be obtained on easier terms than a decade ago. Banks impose lower screening hurdles, smaller down payment requirements, and longer repayment periods which reduces monthly loan servicing costs. However, banks considerably tightened up on their lending criteria in 2008 and those extra controls remain in place.

The mortgage market is dominated by two major Hungarian firms: OTP and the Land Credit and Mortgage Bank, FHB. Foreign banks from Austria, Belgium, Germany and Italy have entered, increasing competition.

Demographic influences

Demographics are playing an important part in stimulating housing demand, with strong growth in the number of households, especially in the metropolitan regions. Currently, there is also an exceptionally large proportion of the population in the 20-24 years old age cohort and they are now entering the housing market as first-time buyers or as tenants.

The population is also ageing, which is contributing to a growth in single person households. Forecasts suggest that the percentage of the population aged over 65 will rise from the current 15% share to 21% in 2025 and 29% in 2050.

Over the longer-term, some fall in the population is expected. It has already dropped slightly over the past decade. The fertility rate is significantly below replacement levels (see Factfile). The actual scale of the change depends on assumptions made about lifestyle choices[10]. If they remain as at present, the population will dip by almost 0.5 million (out of a current 10 million) by 2020 and then remain at around that level. Alternatively, if the household formation habits of the old EU15 prevail, the decline is likely to be much greater with an 800,000 fall by 2020 and a huge 3 million fall by 2050 - although this latter prediction is likely to be unrealistic as it assumes no inward migration, which is unlikely in what will by then be a far more affluent country.

Notable spatial shifts in population are occurring as identified in a recent study of census data, with movements of population from the rural east and the older declining industrial regions. The prime growth area remains the Budapest region. Yet, Budapest itself has seen the loss of 0.5 million people over the past decade as processes of suburbanisation take place there and around the other major cities.

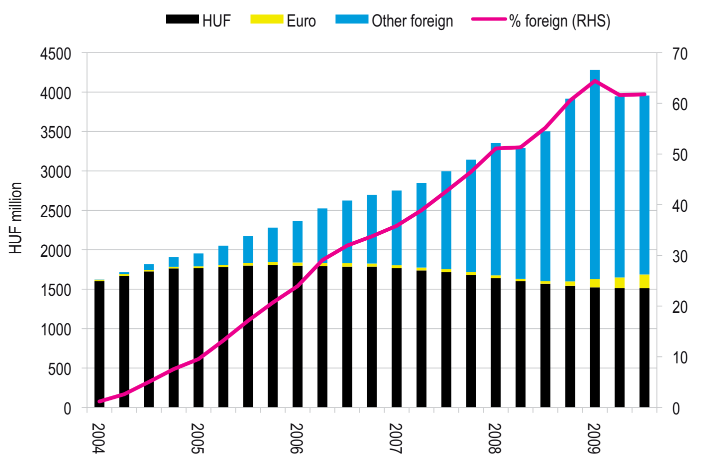

Figure 6.4: Outstanding housing loans and the share of those denominated in foreign currency, 2004–2009

Source: Central Bank

[8]*European Mortgage Federation.*
[9]*Central Bank.*
[10]*Central Statistics Office estimates.*

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Factfile: Hungary

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
10.0	-0.2	1.3	69

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	63	63	63	63	-
Real GDP growth %	3.5	4.0	1.0	0.6	-6.9
Growth in real private consumption %	3.2	1.7	0.4	-0.5	-7.8
Inflation – consumer prices % (HICP)	3.6	3.9	8.0	6.0	4.5
Labour participation rate % (15-65 yrs old in work)	-	-	61	60	61
Employment growth	-	-	0.1	-1.2	-2.0
Unemployment rate %	7.3	7.5	7.4	7.9	9.9

Economic

Sources: Eurostat, OECD.

CHAPTER 7: ITALY

Overview

House prices declined in 2009 but on a relatively moderate scale compared to some other European countries. They were down by 4% in nominal terms, according to both Nomisma and Scenari Immobiliari, and the moderate downswing is likely to continue into 2010, before prices level off. This is mainly due to the continued weakness of the economy, because home owners are relatively debt unencumbered, credit is still available, interest rates on loans are cheap, and there is no supply overhang to worry about.

The absence of a major crash is due to several factors. For one thing, the previous boom had been relatively modest and concentrated in the five year period after the introduction of the euro, when mortgages became readily available at reasonable interest rates for the first time. But since 2005 price rises have been limited. Weak growth, poor consumer confidence, limited demographic pressures and a responsive supply side all contributed to that out-turn.

Housebuilding numbers tend to be difficult to forecast accurately because of the scale of building that takes place outside of the formal building control framework. This institutional framework helps to keep housing supply relatively plentiful but informal building is undertaken to order, which limits the threat of supply overhangs. Physical shortages seem to be greatest in the major cities of the centre and north.

The economy has been weak throughout the 2000s, which has contributed to holding back the housing market, because poor growth constrains consumers' living standards and dampens buyer confidence. The economy was then one of first to be badly hit by the economic crisis and had slid into recession already in 2008. The downturn intensified in 2009 but recovery started in q3 2009.

The conservative banking system was not badly affected by the financial crisis, particularly following ECB support. Mortgages are far less important influences on purchase decisions than they are in many other countries but they have generally remained available for those that fulfil lending criteria. Even so, transactions still fell by 15% in 2009.

Rising interest rates prior to 2009 had for some years helped to suppress mortgage demand and limit price pressures. However, they dropped sharply in 2009 for variable rate products, the most commonly-used type of loan. This encouraged some house purchases, partly offsetting the contemporarily negative economic drivers.

Figure 7.1: House price changes, 1996–2008

** forecast*
Source: Scenari Immobiliari

The housing system

Homeownership is high, with almost three-quarters of residents owning their home (Table 7.1). If co-operative ownership forms are added to the total, the share of owner occupation rises to the mid-80% percentiles. This is matched by a declining share for the private rental market and there is very little social housing. Renting is highest among lower income groups.

Spatially, homeownership shares are highest in the south and in communes of less than 20,000 people. The share of families owning more than one home is decreasing, in parallel with the decline in the rental market.

	1990	2003
Owner occupation	68	73
Rental	25	19
Other forms	5	8

Table 7.1: Tenure shares, 1990 and 2003

Source: Housing Statistics in the EU, 2005/6

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A large part of the stock is in quite poor condition with many buildings in need of significant modernisation. The typical urban form is a dense one. Three-quarters of the housing stock is in multifamily units and 25% of dwellings are in high-rise buildings. Single-family structures are the smallest share of the housing stock in the EU – at only 25% of occupied dwellings[1].

Owner occupation has grown substantially in recent decades, rising from only 59% in 1980. The increase had several causes:

1. The practicability of mortgage borrowing has increased considerably in recent years. Mortgages are far more reasonably priced within the euro zone than under the previous high inflation environment from the 1970s to the mid-1990s.

2. Despite relatively slow economic growth in the country as a whole, living standards have risen, especially in the more economically dynamic areas. Moreover, far more women now go to work, so that two or more income households are now commonplace, making purchase more affordable.

3. Tax breaks are biased towards ownership with mortgage interest relief and low value assessments on imputed income and capital gains taxes. New housing carries a reduced rate of VAT at 4%, though repairs and renovations pay a higher 10% rate.

4. New housing supply is almost exclusively for homeownership, both in terms of new building and the renovation of existing properties. One long-term reason for the low repair standards has been extensive rent controls that had made it unprofitable for landlords to repair.

5. Rent laws changed in the late 1970s and the policy inadvertently enabled landlords to sell out. The Fair Rent Act of 1978 established a common 4-year lease and continued rent controls. This made the dwellings far more valuable in the owner occupied sector than in renting and enabled landlords to sell out when leases came up for their 4 year renewals. The transfer of previous rental properties into owner occupation, furthermore, has been associated with a large renovation programme as developers and households have bought and renovated properties. The shift has not been to everyone's benefit, as it has been accompanied by lengthy legal processes and many evictions of former tenants.

The rental law of 1998 has continued to make private renting typically a limited investment prospect. The standard contract enables the free negotiation of initial rents but commits landlords to four year contracts with the possibility of the tenant exercising the right to another four years' renewal under the same terms. During these contracts, rents can only be raised by 75% of the cost of living index annually. Landlords are likely to 'frontload' the fixed rents of long rental contracts to take account of expected future increases in market rents, unrecoverable inflation and dwelling capital values over the course of contracts. This rental cost-push effect further encourages households to opt for owner occupation at propitious times.

There are also a minority of lettings under 'pre-defined' contracts, which are controlled by local authorities at below market rents fixed by local social housing bodies. The incentives to landlords to accept such terms are exemptions from local property taxes and some lower national taxes as well.

Demographic factors are also influencing the shift to owner occupation. The typical Italian homebuyer is in the older 35-54 age range; whereas renters are more commonly younger or cannot afford homeownership. With an ageing population, demographics are pushing towards a greater propensity to own rather than rent.

The official data suggest that transactions in the rental market are, on average, greater by a third or more annually than those in the owner market, despite the fact that the tenure is over a fifth smaller in size. This not only highlights the higher mobility of renter households, but also the rental laws - because four year contracts imply that, on average, a quarter of contracts will be renewed each year.

[1] *Housing Statistics in the EU 2005/6.*

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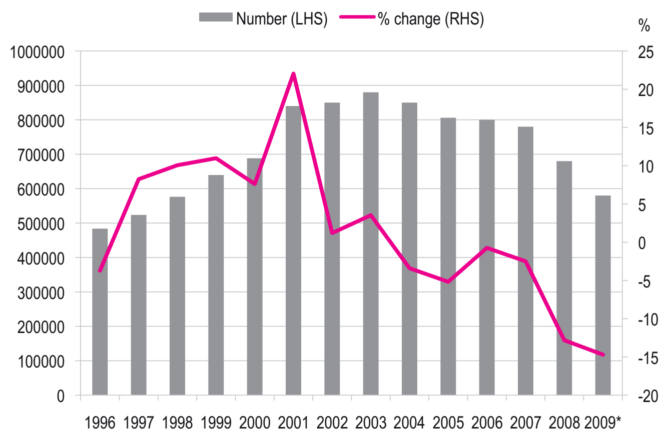

Figure 7.2: House sales, 1996–2009

** forecast*
Source: Ministry of Internal Affairs, Scenari Immobiliari

Figure 7.3: Annual % change in real residential investment, 1998–2009

** forecast*
Source: OECD

Sales data highlight the surge of activity from the mid-1990s to 2003 after which there was a gradual fall for a few years, then a more marked decline as the economy went into recession in 2008 and 2009. These data suggest that a number of structural changes, particularly the introduction of the euro and the growth of mortgage finance in the 2000s, have been overlain on a relatively long housing market cycle that lasted from the mid-1990s to the late 2000s (Figure 7.2).

Housing supply

Recorded housing investment expanded steadily but moderately from the late 1990s through to 2008, both because of new building and improvement (Figure 7.3). The data are unlikely to account fully for the large amounts of ‘illegal’ building that takes place in the country. The drop in building during 2008 corresponds to the general weakening of the economy and housing market activity but is modest in relation to most other European countries.

It is hard to assess whether supply is adequate, because illegal building has been widespread for many years and there is no way of knowing whether it is rising or falling in scale. Most of this unrecorded output is scattered development in the suburbs and urban peripheries. There is, consequently, still a limited supply of housing available for sale on the market in the places where demand is strongest - in particular, there remain shortages of high-quality, well-located accommodation. New housebuilding, for example, is estimated to represent around 15% of the housing market nationally but only 5% in the major cities, where demand pressures have been greatest[2]. Local planning constraints can be substantial when the rules are enforced.

New recorded building investment is falling relative to maintenance and renovation. Investment in residential renovation and improvement is the most important market in the construction sector. Renovations showed strong growth prior to the downturn, helped by tax incentives. Renovation has been encouraged by the trend amongst some affluent and younger households to live closer to city centres in attractive and historic neighbourhoods.

Limited long-term increases in house prices overall suggests that the supply situation is quite elastic over the long-run. The often informal nature of building means that much of the new housing and renovation fails to make it onto building permit, tax and data registers. Periodic amnesties eventually bring some of them into the fold.

[2]*Scenari Immobiliari Forecast Report 2006.*

CHAPTER 7: ITALY

Macroeconomic influences

2008 saw the onset of recession, with output falling by 1%, driven by declines in domestic private sector activity and a sharp decline in exports. The recession intensified during 2009, with the economy contracting by almost 5% according to Eurostat. The economy should grow again in 2010 but only in a lacklustre way.

The country has some deep-seated economic problems. Competitiveness has been eroded by low productivity growth, high costs and an industrial structure vulnerable to competition from Asian economies. Governments have found it hard to introduce major economic reforms and the government deficit and national debt are stubbornly high, which meant that it was not possible for the government to introduce a stimulus package to offset the slide in the economy in 2008 and 2009. However, falling euro zone interest rates have had a positive impact.

Inflation was around the ECB's target 2% level for several years but rose to 3.6% in 2008. However, falling commodity prices and the slowing economy reduced it again in 2009 and it is likely to remain low due to extensive excess capacity in the economy.

Unemployment has been rising during the recession and is approaching 9% and is likely to stay around that level in the expected weak recovery. There are wide regional variations, with the unemployment rate over 20% in the South. Overall involvement in the labour market is still relatively low. At only 63% of the working age population, it is one of the lowest in Europe.

Mortgage market influences

A well-established mortgage market is fairly recent. Outstanding mortgages were only 20% of GDP in 2008, up from 6% in 1990[3]. Many dwelling purchasers still do not use mortgage facilities, despite the apparent tax benefits of doing so. The residential market, of course, has been for a long time the final resting place for undeclared earnings. Yet, with the stability that euro zone membership offers and a tightening tax net, the value of mortgage debt is expected to continue to grow rapidly in the future as the use of residential mortgages expands.

Because of the low level of mortgage debt, Italy has an exceptionally low level of personal borrowing for an affluent society. The overall ratio of long-term household debt to household disposable income was only 41% in 2007, less than in any of the world's major economies. Recent growth in borrowing has been significant, with the share of long term household debt to disposable income doubling in the decade up to 2006[4].

One factor holding back mortgage growth is the difficulty banks can have in recovering bad debts. Reforms have been made in recent years but the debt recovery process through the courts remains slow, cumbersome and costly. Such problems discourage potential lenders from entering the market, though spreads on mortgages do not seem out of line with elsewhere in the EU. Nonetheless, lenders may be forced by the higher repayment risk to impose tighter screening criteria on borrowers than in some other countries.

New laws were introduced in 2006 and 2007 aimed at liberalising retail banking. The onset of the financial crisis has subsequently held back change but over time these measures should have a significant impact on the mortgage market. Specifically in relation to mortgages, transfers from one provider to another have been made easier and the legislation has banned penalties on early mortgage redemption. This will have significant knock-on effects as it allows borrowers to remortgage more easily.

Mortgage advances were consistently expanding until 2008 since when they dipped somewhat, because of the slowing housing market and the problems associated with the credit crunch, but then grew slightly again in 2009 (Figure 7.4).

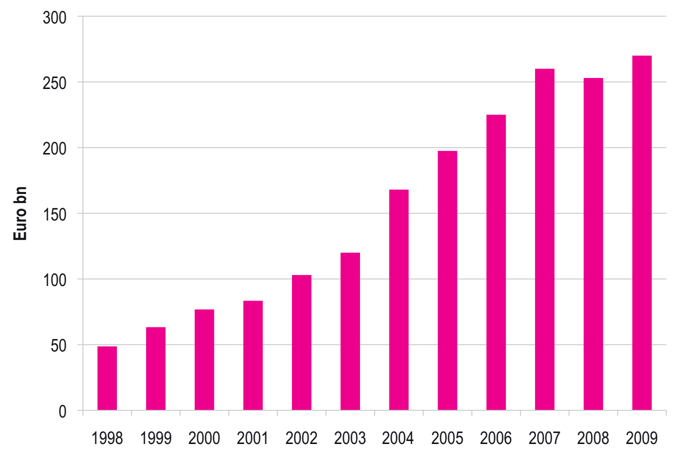

Figure 7.4: Residential mortgage advances to households, 1998–2009

Sources: Central Bank, Scenari Immobiliari

[3] *European Mortgage Federation.*
[4] *OECD.*

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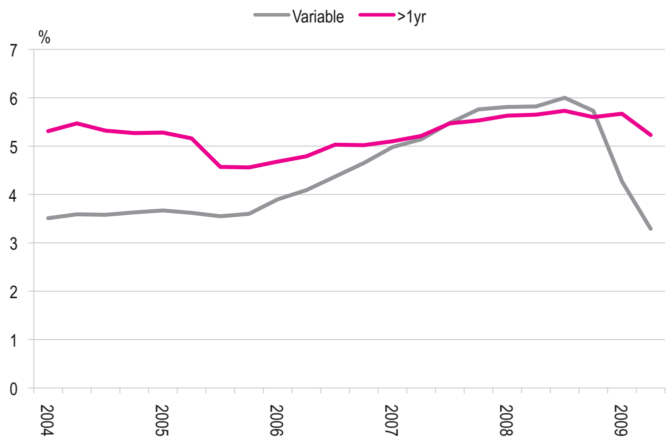


Figure 7.5: Housing loan interest rates, 2004–2009

Source: Central Bank

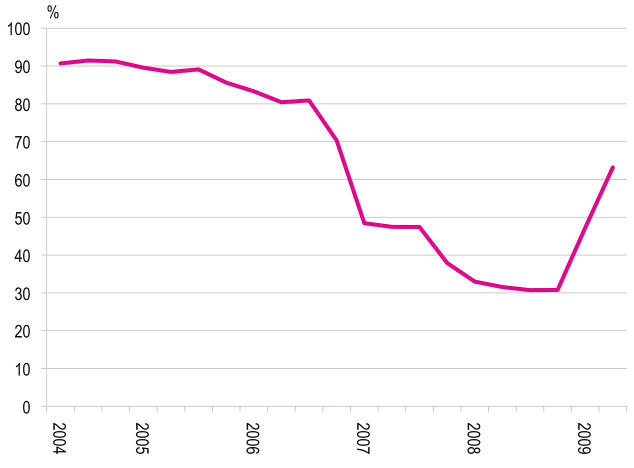


Figure 7.6: Share of variable interest rate mortgages, 2004–2009

Source: Central Bank

Interest rates rose, particularly variable ones, from 2006, peaking at the end of 2008. Lower inflation and greater financial stability have seen variable rates fall again, so that they are currently around 3.25%, though they are expected to rise as the ECB tightens monetary policy in 2010 (Figure 7.5).

The marked variations in interest rates between fixed and variable rate mortgages has led to considerable variations over time in the market shares of both products. In the first half of the 2000s, variable rate mortgages had a commanding share of around 90% but this fell to only a third in 2008 as variable rates rose above fixed ones, only to increase sharply again in 2009 (Figure 7.6).

Mortgages are lent by commercial banks. In recent years, foreign banks from elsewhere in the EU have moved into the Italian market and they have played an important part in stimulating mortgage lending. They include Dutch and UK banks. Their entry was encouraged by the existence of the euro zone because it lowered exchange rate and other financial risks of operating in a country that once had chronically high and volatile exchange and inflation rates.

CHAPTER 7: ITALY

Demographic influences

The total population is growing slowly, with natural declines being offset by immigration. Current household numbers of 20.5 million are also rising moderately.

Overall, population is decreasing in the major cities and increasing in the smaller centres. Moreover, there has been a long-term trend, as elsewhere, for residents to move away from the city centre to the suburbs – although this trend is now associated with a counter inwards movement towards the city centres.

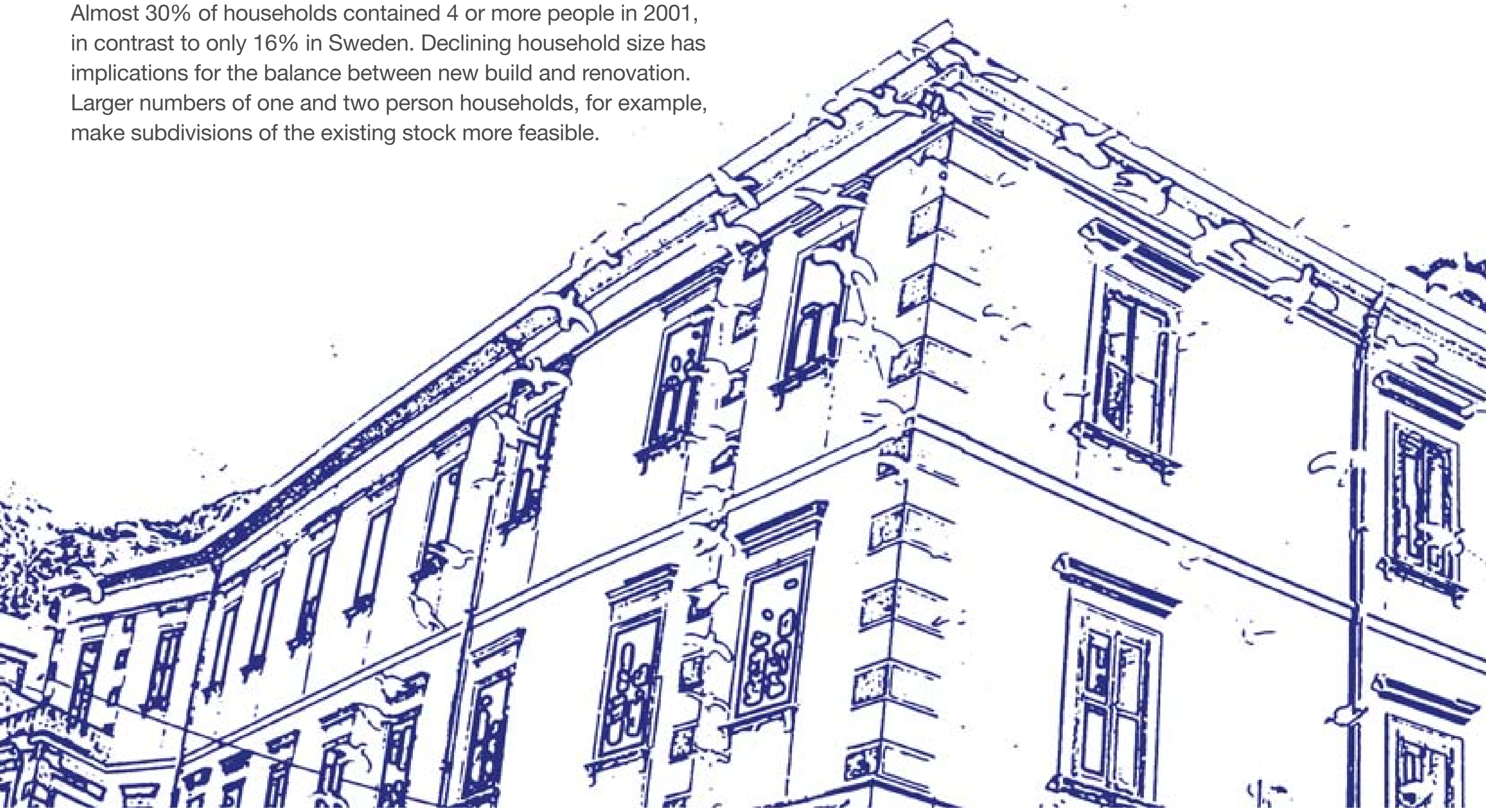
The total population is expected to grow slowly and increase by 2 million over next 30 years[5]. At the same time, the population will be ageing and life expectancy high and rising. The result is that the country will experience one of the greatest demographic shocks of all advanced nations. The dependency ratio (share of those age 65 and over as a percentage of those of working age) is currently 31% but is expected to almost double over the next 40 years[6]. Such a transformation is likely to have profound effects on the housing market.

Future household numbers are expected to increase somewhat over the next decade (although there are no official projections). Average household size is falling, although at 2.6 persons per household it is still much higher than in northern European countries[7]. However, it is close to the European average in the north of the country and much higher in the south.

Almost 30% of households contained 4 or more people in 2001, in contrast to only 16% in Sweden. Declining household size has implications for the balance between new build and renovation. Larger numbers of one and two person households, for example, make subdivisions of the existing stock more feasible.

There is a long tradition of family members living together for longer periods of their life cycles than is common in many northern European countries. Italy, for instance, has the highest percentage in the EU of 20 year olds still living in the parental home (96%). This lifestyle often persists through a person's twenties, with 43% of men and 27% of women still living with their parents when they reach thirty[8]. In part, such behaviour is the result of social preferences, but it has also been based on a history of chronic housing shortages. So, it is to be expected that as affluence grows and housing conditions improve then progressively more people will set up independent households, further lowering average household size.

Net inward migration has been rising rapidly over the past decade and there are now 2.5 million foreign residents[9]. Immigrants include retirees from other EU countries as well as from those coming to find a better life from around the Mediterranean basin and beyond. Approximately 300,000 foreigners are homeowners. They are now involved in 17% of purchase transactions. 1.2 million more live in decent rented accommodation but almost a million endure sub-standard conditions. This is creating a huge new housing problem for the country at a time when government finances are in poor shape and private sector investment is discouraged by rent controls and other regulations.



[5]*Eurostat.*
[6]*Eurostat.*
[7]*In 2000. Housing Statistics in the EU, 2001, Finnish Ministry of Housing.*

[8]*Mid-1990s data. 'Household scenarios for the EU, 1995-2025', Statistics Netherlands.*
[9]*Eurostat.*

CHAPTER 7: ITALY

Factfile: Italy

Population (m) 2008	Annual population Growth %, 2008	Fertility rate* 2006	Years life expectancy 2006
59.6	0.8	1.4	79

Background

* Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	105	104	102	101	-
Real GDP growth %	0.8	2.1	1.5	-0.1	-4.8
Growth in real private consumption %	1.2	1.3	1.2	-0.9	-1.9
Inflation – consumer prices % (HICP)	2.2	2.2	2.0	3.5	0.7
Labour participation rate % (15–65 yrs old in work)	-	-	63	63	63
Employment growth	-	-	1.0	0.8	-0.9
Unemployment rate %	7.8	6.8	6.2	6.8	7.6

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	5.3	4.1	1.1	-0.9	-6.6

Housing market

- Owner occupied housing: mortgage interest relief – yes
- Capital gains exempt – no
- Imputed rental income – taxed
- Stamp duty: 3%
- VAT on new dwellings: 4%
- Property taxes as share of all taxes 2002: 5%
- Property taxes as share of GDP 2002: 2%

Taxes

Sources: Eurostat, OECD.

CHAPTER 8: NETHERLANDS

Overview

The resilient Netherlands housing market finally cracked in the autumn of 2008. Transaction volumes had been drifting slowly down since 2006 but then dramatically dropped by a third, from around 15,000 a month to around 10,000 only in late 2008 and early 2009, and house prices started to decline in 2008. However, that decline turned out to relatively moderate, with prices falling by 6% between August 2008 and September 2009 - and a slight upturn occurring during the next month, October 2009 (Figure 8.1). The official house price index is based on property register data, which lag current deals by several months. Other indicators suggested a stronger performance, so the market seemed to be stabilising by the autumn of 2009 but remained fragile.

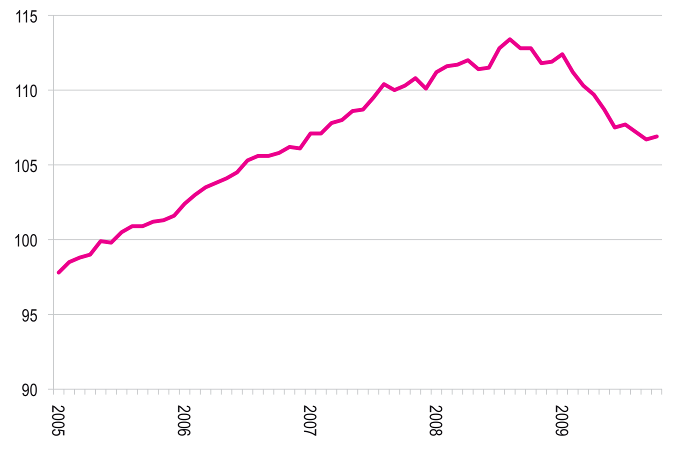


Figure 8.1: Monthly house price index, Jan 2005–Oct 2009

Source: Netherlands Statistics

Housebuilding has been affected by the slowdown. Permits for new owner occupied homes fell by 18% in the first half of 2009 compared to a year earlier. Yet, total completions were only down by a modest 4%; helped partly by an increase in social housebuilding[1].

The relatively muted downturn in house prices to date occurred despite the substantial impact of the financial crisis on the economy and financial system. ABN Amro and Fortis Bank Nederland were taken over by the state in the aftermath of the collapse late in 2008 of Fortis, their parent company, with a €25 billion bail-out by the end of 2009, and the state also injected funds into other banks. Banks sharply tightened mortgage lending criteria and households showed less interest in borrowing as confidence in the housing market declined. Mortgage lending growth declined throughout 2009, though according to the central bank still rose somewhat.

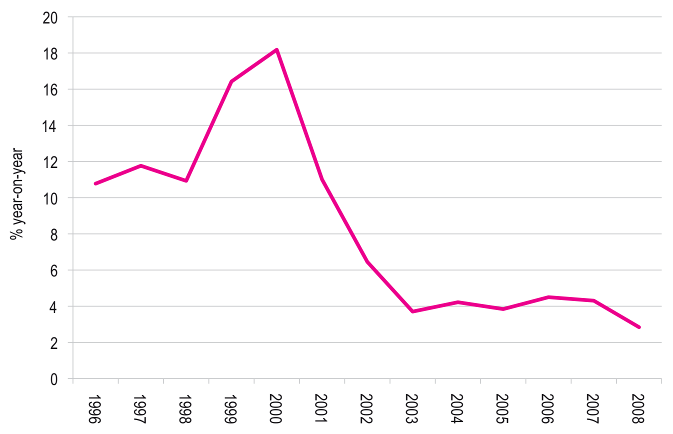


Figure 8.2: House price changes, 1996–2008

Source: Netherlands Statistics

The country has also been badly hit by the economic downturn and the economy was set to decline by almost 4.5% in 2009 and to remain flat during 2010. Unsurprisingly in the circumstances, unemployment is on the rise, though from low levels.

The period of the most rapid house price increases was earlier than in much of the rest of Europe, occurring during the second half of the 1990s and the early 2000s. From 2003 onwards, price growth moderated to around 4% a year, so the country's sharp surge in prices had moderated a long time before the world financial crisis began. Even so, prices remain far higher than prior to the boom; being roughly double in real terms what they were in the mid-1990s.

[1]*Statistics Netherlands.*

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The housing market was sustained by record levels of borrowing throughout the 2000s, at high average loan to value ratios. The level of mortgage indebtedness of many owner occupiers is exceptional by international standards. An inducement to high levels of borrowing is mortgage interest tax relief (MITR) in a country with high marginal rates of taxation, so that consumers have a strong incentive to load debt onto housing.

Prices in Amsterdam rose faster than national ones for most of the years of rapid price rises but prices there have also been more volatile. They fell somewhat in the slowdown of 2003 and experienced greater decline during 2009 as well, falling by 10% between q3 2008 and q3 2009[2]. Other major cities have experienced somewhat slower than average price rises and falls, partly because much of the demand for owner occupied housing outside of Amsterdam has been associated with suburbanisation and medium and small urban areas.

The onset of the economic crisis led to a package of economic stimulus measures being introduced in March 2009, which included a €395 million inner city housebuilding and urban improvement package. The construction subsidy is up to €10,000 per home built for either renting or ownership and will mean that a large proportion of dwellings built in 2009 and 2010 will receive a subsidy. The National Mortgage Guarantee Scheme (NHG) has also been temporarily increased until the end of 2010 to a maximum level of €350,000 so that more people are eligible for an NHG mortgage; both in order to encourage more purchasers and to induce lenders to offer more loans.

The housing system

30% of the housing stock is in the form of apartments and the rest is single family dwellings. Of those single family dwellings, two-thirds are terraced houses. Although the housing stock is ageing, given low current building rates, it remains relatively young by European standards; with only 20% dating back to before 1945[3].

In view of the country's apparent land constraint, it is perhaps surprising to realise that the average Dutch dwelling is one of the most spacious in Europe and that there is a relatively large availability of living space per inhabitant. Average useful floor areas are more than ten per cent greater than in Belgium, France or the UK, for example. Newly built homes also tend to be more spacious than existing ones.

The country has a tradition of dense urban forms, which have been encouraged by long-standing planning practices and the high cost of preparing land for housebuilding. Dense urban patterns, and the policies underpinning them, are now subject to intense pressures, arising from a desire for better standards, easy commuting and more spacious housing.

The state, at local and national levels, plays an important role in housebuilding as a key land developer. Until the 1990s, it undertook virtually all of the land development function. Although private developers have been more active in land markets in recent years, residential land is still mainly brought on stream by local authorities. Such a scale of public sector initiation of land development is unique in Europe and gives considerable power over housebuilding to highly interventionist public land-use planning.

[2] *NVM.*
[3] *Ministry of Housing, Spatial Planning and Environment.*

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Owner occupation

Traditionally, the housing system was characterised by a relatively low level of owner occupation and a very large social housing sector. Recent years have seen a marked expansion of homeownership, at around 53% of the occupied stock in 2007 - up from 42% in 1980[4]. This homeownership share is still low by international standards but, even so, growth in owner occupation helped to stimulate the upward shift in house prices. How the share will increase further strongly depends on public policy, because three-quarters of rental housing is in the social sector and it has proved politically easiest to expand housebuilding there.

Owner occupation rates are far lower than the national average in some cities. Amsterdam had only 30% and Rotterdam 59% in 2007. This may help to explain the exceptionally high prices of houses in some of these cities and trends towards suburbanisation, because homes for sale are such small proportions of the available stock.

Transaction cost taxes are relatively high. Purchasers of new houses pay 19% VAT and existing houses are subject to a 6% property transfer tax. Yet, overall, property taxes (including those on non-residential structures) are quite small. Mortgage interest tax relief is available to owner occupiers. The OECD amongst others has been vocal in arguing that this distortionary subsidy should be withdrawn. In addition, the capital gains from rising house prices are not taxed.

A property tax was traditionally levied by municipalities separately on occupancy and ownership. However, the tax on dwelling use was abolished with effect from 2006, leading to a loss of municipal income of almost a billion euros and a commensurate reduction in housing costs. On the ownership side, the capital value of dwellings for assessment purposes is based on the Valuation of Immovable Property Act (known by the acronym, WOZ). They lag housing market values by several years. A complex set of variations meant that in practice ownership taxes rise by relatively small amounts overall. The government also aims as part of its long-term agenda to reduce the tax paid on dwellings worth over one million euros.

A Promotion of Homeownership Act was introduced in 2001 to enable people on lower incomes to buy their own home. In 2007, the loan amount was increased to approximately €170,000 from €105,000 previously and the income cap was raised from €29,000 to €34,000. Its stipulations mean that it is most likely to be used for the sale of social housing to sitting tenants[5]. Each year a cap is put on the budget for this programme. A scheme also exists to subsidise first-time buyers' loans. Under it, local authorities can advance loans as additions to standard mortgages, with half of the loans' costs subsidised.

A shift in housing policy

The state has long had a highly interventionist role in housing. Housing for many years has been a controversial issue at the top of the political agenda, because of such factors as acute housing shortages for movers and new households; social tensions, particularly in relation to ethnic minority communities; and growing problems of affordability, especially entry barriers to owner occupation.

Housing policy was subject to much inter-party negotiation during the formation of the current coalition government in 2007, which has had a considerable influence on housing trends. In particular, the coalition's declaration on housing policy seems to mark a significant move away from the previous liberal, more market-oriented policy stance, which aimed at lowering the degree of state involvement in housing provision. A previous commitment to increase owner occupation is now downplayed, and earlier planned increases in social housing rents have now been abandoned. They will now rise only by the rate of inflation for an indefinite period. Moves towards creating more liberalised rental housing out of parts of the social and private sectors have been shelved as well. Planning constraints also seem to have intensified.

80% of new housing is planned to be built on brownfield sites with an emphasis on inner city redevelopment, self-contained communities and preserving the 'Green Heart' of the Randstad. Strong state intervention is at the centre of this low spatial mobility, neighbourhood-oriented policy.

Social housing

Social housing as a share of all dwellings reached a substantial peak of 38% in 1998. Since then it has declined marginally to 34%, though this is still by far the largest share for social housing in the EU. The growth of the social sector up to the mid-1990s was accompanied by a sharp fall in private renting, which now houses only about 10% of the population compared to 24% in 1980[6]. Most new rental properties are now built in the social sector.

Social housing providers are called housing corporations (equivalent to British housing associations). They are independent, private but non-profit, institutions. The 455 of them own 2.4 million units: 36% of their dwellings are in the low-rent category (almost 60% in Amsterdam and Rotterdam); 58% affordable; and 6% high rent[7]. Many are large entities, particularly after recent mergers, and they form a key pillar of the Dutch 'Polder model', based on cooperation and negotiation between state and non-state entities.

[4] *Statistics Netherlands.*
[5] *Ministry of Housing, Spatial Planning and Environment.*

[6] *Housing Statistics in the European Union 2004.*
[7] *Ministry of Housing, Spatial Planning and Environment.*

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Given their large portfolios of properties, on which there is little secured debt and a steady rental income, housing corporations tend to be wealthy organisations subject to few financial pressures even though they receive no direct public subsidies and now pay corporation tax. The Aedex/IPD Dutch social housing index has shown gross returns (net of property management costs but before overheads and other organisational expenses) averaging -1.3% in 2007. The income return was positive at 2.3% and has been stable over time, but the total return was depressed by falling capital valuations, reflecting performance of the wider housing market.

Housing corporations are under frequent pressure to respond positively to government policy initiatives. Local authorities are also empowered to monitor local agreements made with them in order to ensure that agreed housebuilding targets are met and are able to allocate households to tenancies. In recent years, governments have particularly relied on housing corporations to build homes to overcome current shortages, thereby avoiding the need for direct government funding of building programmes. For example, the corporations built 25,000 new rental dwellings in 2007 (and demolished 16,000). This construction effort has been further leveraged by the temporary housebuilding subsidies announced for 2009 and 2010, noted earlier.

Urban regeneration has moved up the political agenda because of social tensions, rundown social housing neighbourhoods and increasing spatial segregation. Housing allocation policies, renovation and building policies and the long-run movement of middle-income groups out of social housing into owner occupation are leading to high levels of spatial segregation of ethnic minority groups. Much of the social stock is now ageing, with a significant proportion located in increasingly rundown neighbourhoods. For the big cities like Amsterdam, which have large shares of their housing stock in the social sector, urban decay and increased social polarisation are growing problems.

The housing corporations have become significant providers of new owner occupied housing and currently almost 60% of their construction is outside the affordable sector. Sales of existing social housing stock are running at around 15,000 properties a year, according to VROM data. Though significant, this is unlikely to lead to much alteration in the scale of the social sector in overall housing provision.

Rent controls

With the exception of the small up-market sector, which represents 5% of all rental dwellings, rents are controlled, with the same legislation applying to both the private and social sectors. Security of tenure is guaranteed – temporary contracts are forbidden – and tenancies can be passed onto spouses, children and others. Rents bear little relation to market levels but rather to a points system related to amenities and to service charges. If landlords do not keep up repairs, tenants can apply for rent reductions, and rents can only be raised annually by a maximum amount decreed by the government. From 2009, tenants will also be able to request 'reasonable' improvements to their dwellings which landlords will be obliged to carry out. Despite the long boom in house prices, real rent increases have been limited.

Under the previous government, a new longer term view was taking shape. Tentative moves towards a more market-oriented approach were made, with plans slowly to liberalise parts of the controlled rent stock. Some real increases in rents were also going to be permitted. However, this programme was abandoned in 2007 during the inter-party negotiations to form the current government and future rent rises shall follow general price inflation.

While freezing real rent levels is popular with many of the 40% of Dutch households that are directly affected by them, rent controls and low rent policies distort the operation of the housing market with long-term adverse consequences. Households are encouraged to consume excessive amounts of housing, leading to greater shortages than there need be. Housing providers have less income for investment. Within that rationing system, existing tenants are favoured over new households and movers, leading to regressive distribution effects and enhanced social segregation. Households are induced to behave in ways that conform to social housing's access rules, which often work against labour market and other welfare policies. Informal and illegal rental markets are encouraged. General mobility is reduced. Another implication is that demand shocks result in queues and intense pressures on households to become owner occupiers because that is effectively the only free market housing option in most localities. Price volatility in the owner occupied sector is exacerbated as a result. In summary, such rent control policies lead to general welfare losses rather than gains.

Around €1.5bn is spent annually on housing allowances in both the social and private rented sectors. The average annual allowance is about €1,700, with 30% of tenants – just over a million households – receiving it[8]. As an economy measure the level of subsidy is being reduced somewhat on a stepped basis from January 2010, so that households will eventually have to contribute around €3 more to their rents a month[9].

[8] *VROM.*
[9] *VROM.*

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Privately rented housing

Around 10% of the stock is rented privately, amounting to approximately 750,000 dwellings. Around a quarter of the private rented sector consists of a higher rent 'free' market and the rest is subject to similar rent controls to the social sector.

There are two types of institutional private landlord. One consists of a small landlord sector of individuals and small firms, including room letting companies, and the other is a large landlord sector owned predominantly by around 30 institutional investors, holding portfolios collectively amounting to around 150,000 properties.

Housing in the small landlord segment primarily consists of lower quality, moderate rent, small, pre-war dwellings in inner city areas. Institutionally-owned rental housing is in marked contrast to the small landlord sector. Much of it has been built over the past thirty years, predominantly in good city locations. The units are generally spacious, well-equipped and maintained to a much higher standard. The free rent elements of their portfolios are popular among mobile, affluent households.

Direct residential investment is common for Dutch pension funds and insurance companies. The ROZ/IPD residential index - based on about 2,500 properties worth €20m, equally split between single family houses and apartments - recorded a total return of 3.3% for 2008 of which 5.1% was income return and the rest negative capital growth. The quarterly index highlighted a substantial decline in performance in the last quarter of 2008 and then showed improvement during 2009, although total returns were still only just positive in q3 2009.

Investing in controlled private rental housing is generally not particularly profitable, unless the investment was purchased for an attractive price or it leads to capital gains from subsequent sales of properties. Over the long-term, a regulated private rental sector cannot hope to compete with the tax breaks offered to owner occupiers nor the financial power of the social housing institutions. This induces sales when market and security of tenure conditions permit. So, without radical reform, the sector will continue to play only a modest role.

The Association of Institutional Property Investors (IVBN) submitted a complaint to the EU Competition Commissioner about the increasing role of state-aided social housing institutions in commercial markets. IVBN members own 130,000 homes in the Netherlands and form a major part of the private rented sector.

The lack of a substantial free market privately rented sector has consequences for household life cycles and the stability of the owner occupier market. In the absence of an effective rental option and with the existence of the attractive subsidies offered to homeowners, many younger households embark on risky purchase and large mortgage commitments at a young age. That the Netherlands chooses not to use the capital resources of the small investor to provide affordable accommodation for fellow citizens, common in so many other countries, is one of the major peculiarities of its housing policies.

Housebuilding

Total output declined steadily from the late 1980s, when around 110,000 dwellings were built annually, to a low of less than 60,000 in 2003 (Figure 8.3). Since then, private housing picked up somewhat until 2007 but it has been badly affected by the crisis. By contrast, social housing output has almost doubled since 2002 and with the Government's current stimulus measures will continue to increase during 2010.

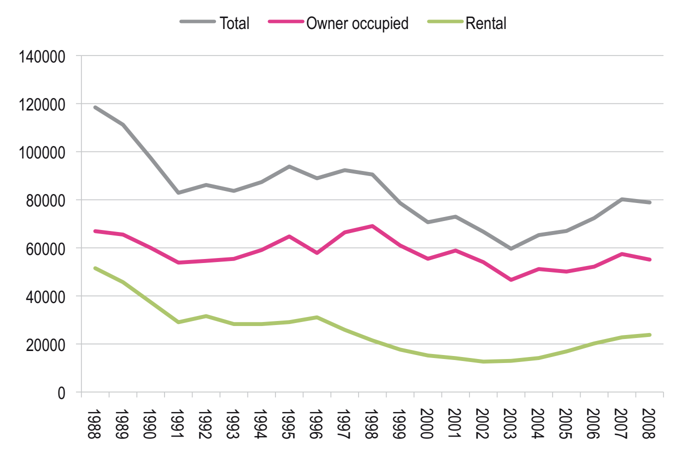

Figure 8.3: Housing completions by tenure, 1988–2008

Source: Statistics Netherlands

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The scale of the long run decline in housebuilding has been substantial. The annual level of private housebuilding actually fell by 25% between 1998 and 2004, even though house prices were much higher at that later date. This paradox has provoked considerable debate, with the planning system and associated local authority provision of development land blamed by many commentators for most of the problems.

Land release in the Netherlands is influenced by a rigorous planning regime and by the costly site infrastructure provision in a country where much of the land is below sea level or otherwise expensive to convert. Institutional practices are such that the land development process is principally organised by local authorities. Most housing is required in the Randstad core of the country but there is a long tradition of protecting its 'green heart' from building. Added to this are general concerns about the environment. They have been interpreted in an anti-development way familiar in other countries.

Recent planning strategies, such as the 'VINEX' one initiated in the 1990s, have tried to direct most development to a limited number of brownfield sites and to a handful of large-scale, suburban localities – with the latter aimed at creating, environmentally sustainable, mini new towns. The outcome is now widely recognised to have limited housing output. Problems arise in getting development underway, so it either does not happen or takes years to come on stream. Also, the mix of housing created is often inappropriate to satisfy market demand.

The last government was beginning to introduce measures to allow somewhat more market-sensitive, dispersed developments. A shift was announced away from 'imposing restrictions' to one of 'promoting development', although the general principles of strict planning and inter-agent consensus over development remained. Under the latest government the relaxation of planning controls has been reversed. Instead, the VROM housing ministry has entered into agreements with local authorities in areas where development is less controversial and public-private partnerships are being encouraged. For example, it announced in November, 2009 that the 'new town' of Almere is to expand by 60,000 dwellings up to 2030 and gradually be linked into the Amsterdam conurbation. Countrywide, 40% of new building is expected to be on brownfield land but sites are relatively limited. As many as 440,000 extra homes are forecast to be needed in the Randstad area by 2030, so planning dilemmas are likely to remain.

Whether a state-interventionist approach - with housing providers steered into meeting plan targets - is compatible with a market-driven housing system is a matter of debate and some scepticism. If too much emphasis is put on the efforts of housing corporations, social mix and owner occupation goals will be unfulfilled. The dilemmas of Dutch housing policy remain as strong as ever.

A feature of housebuilding is that the average completion time of dwellings from the point when a building permit is issued to the actual finished construction of the dwelling is long and rising. In 1995, the average completion time was 13 months but it rose to 18 months in 2006. More detailed examination of the data shows that the skew of completion times has shifted. In the mid-1990s almost half of all dwellings were completed in less than a year; that number has now dropped to a fifth, while those taking more than 2 years have risen from a negligible amount to 30% of all dwellings. This suggests that the complexity of building projects has grown considerably, probably because of the changed nature of the development land on which housebuilding is permitted[10].

An extended length of building time, of course, tends to raise construction costs and in the Netherlands they typically rise faster than the general rate of price inflation, although the current downswing has moderated them. The cost of housing construction is gradually rising over time, putting further strain on the country's ability to increase its housing supply.

[10] *Netherlands Statistics.*

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Macroeconomic influences

The country has one of the highest standards of living in the EU, a third higher per capita than the average. This has been achieved over many years and has been sustained by a strong economy for much of the past decade. Growth was particularly strong in 2006 and 2007[11]. However, the general world economic slowdown in 2008 brought expansion to a halt, especially as the Netherlands has such an open economy, and the economy contracted by 4% in 2009. Exports and investment were particularly badly hit and competiveness was lowered by the increase in the value of the euro. Financial services in particular are in retrenchment, as the financial crisis badly hit the country's leading banks, and marked deleveraging is taking place.

A weak recovery is now underway in line with developments elsewhere in the euro zone. Growth should strengthen from 2011, bar any further financial or economic shocks. The household savings rate has risen to 10% as consumer confidence has contracted, lowering consumers' expenditure, and is expected to remain at that level for some years at least. Confidence was returning in late 2009 but the continued weakness of consumer expenditure is likely to be reflected in a weak housing market for some time yet.

Inflation is now low and expected to remain so, after rising somewhat during 2007 and 2008 due to the impact of commodity prices. Growing unemployment and excess capacity in the economy mean that price rises will remain muted.

Emergency measures to bail out banks and stimulate the economy plus the normal fiscal dynamics of recession have all plunged the government fiscal balance into deficit, which the OECD expects will rise to 6% in 2010 and remain high. This will inevitably put pressure on public expenditure as recovery continues. In such circumstances, government subsidies to housebuilding are unlikely to be renewed when the current programme runs out in 2010. Whether the private housing market will be strong enough by then to pick up the slack is uncertain. Urban regeneration programmes will also face constraints. The country's long-term housing supply problem does not look as if it is going to improve at any time in the near future.

Mortgage market influences

There are a variety of mortgage lenders. The most important ones are general banks. Two of the largest are now merged and nationalised, ABN Amro and Fortis. Another, ING (including Postbank), has received significant injections of state capital. So, the mortgage market is now effectively state-run. There are some specialist mortgage banks and building funds ('bouwfondsen'), and insurance companies and pension funds also directly provide mortgage finance. But all of them amount to only 5% of the mortgage market compared to the overwhelming role of the banks. In the past, competition between the leading bank lenders was intense but the impact of recent mergers, bailouts and the credit crunch has lowered competitive pressures significantly, enabling lenders to increase spreads.

Prior to the credit crunch, almost a fifth of mortgage lending was actually outside of the country because Dutch banks wished to participate in internationalisation trends and they moved into foreign markets, especially into new EU member states, the USA and Asia. The acquisition and breakup of ABN-Amro by a consortium of European banks and the credit crunch have now curtailed such activities and Dutch financial institutions have become 're-domesticated'.

A large part of the financial system is now state owned, heavily subsidised, able to issue state-guaranteed paper, and raises much of its liquidity needs from the ECB, posting securities as collateral. This ECB facility has become an important route through which mortgage finance has been sustained since the advent of the world financial crisis.

[11] *OECD and CPB, Netherlands Bureau of Economic Policy Analysis.*

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Securitisation has been an important feature of the mortgage market in recent years. Under this arrangement, banks sell their residential mortgages onto special purpose vehicles (SPVs), which issue new securities on the basis of them (RMBS). By 2007, the Netherlands had become the third largest European issuer of securitised mortgage debt after the UK and Spain, in spite of its much smaller size. Securitisation now accounts for 35% of all outstanding mortgage debt (Figure 8.4), whereas it was only 5% in 2003 and 26% in q3 2008[12]. As private capital markets remain virtually closed to RMBS, the role of the ECB has been central to the sustenance and continued expansion of this market. The experience of Dutch RMBS market is consequently in sharp contrast to that of the UK, where it all but ceased to exist after autumn 2007, and reflects key differences in the characteristics of the securities, monetary policy and government actions, including the offering of mortgage guarantees.

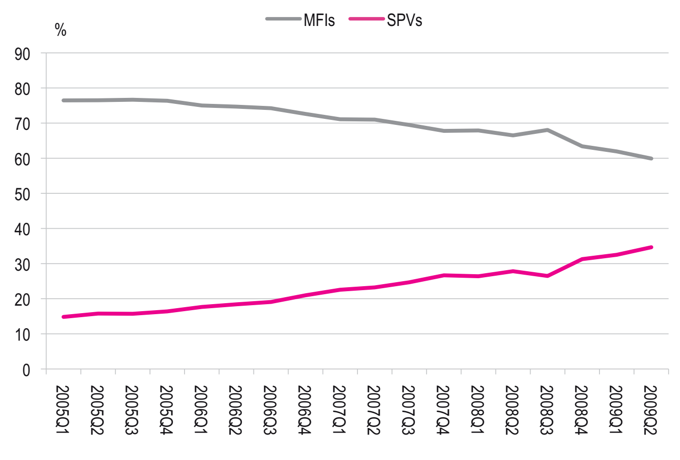

Figure 8.4: Mortgage market shares of monetary-financial institutions (MFI) and special purpose vehicles (SPV), 2005–2009

Source: Central Bank

Overall mortgage lending had been growing strongly for over a decade, with lending rising over threefold between 1998 and 2009 in nominal terms[13]. Growth rates have been declining since 2006 but were still over 4% in autumn 2009 on an annual basis (Figure 8.5). Although the housing market has slowed down, new purchasers typically need larger mortgages than sellers because of the growth in house prices over the past decade.

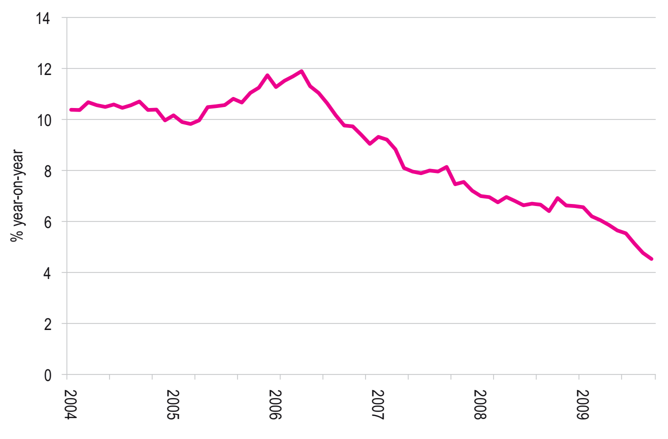

Figure 8.5: Mortgage lending, Jan 2004–Sep 2009

Source: Netherlands Central Bank

Lenders have been tightening loan criteria, which is heightening mortgage rationing. Some potentially eligible borrowers are also being put off by concerns about the weakness of the housing market.

Consumers often obtain mortgage packages, financed with a mix of first and second mortgages, containing various potential combinations of payback terms and fixed and variable interest rates. Overall mortgage lending was divided fairly evenly between floating, 1-5 year fixed, and 5-10 year fixed at the end of 2009. In the year since autumn 2008, when mortgage interest rates peaked at the height of the credit crunch, interest rates have come down significantly. Floating rate mortgages, for example, carried an average rate of 4%[14]. Reasonable mortgage availability and relatively low nominal interest rates together help to explain why the housing market has weathered the crisis relatively unscathed to date, despite the sharp general economic contraction.

A National Mortgage Guarantee ('Nationale Hypotheek Garantie') was set up by the government in the mid-1990s to encourage lower income homeownership. Homebuyers may insure their risk of default by paying a small insurance premium (0.15 percent of the mortgage loan until recently). About a third of mortgages are guaranteed in this way. The existence of such a guarantee must contribute to lenders' willingness to lend large sums to higher risk borrowers.

[12] *Netherlands Central Bank.*
[13] *Netherlands Central Bank.*
[14] *Netherlands Central Bank.*

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Demographic influences

One of the most notable demographic factors of the past 20 years has been a large increase in household numbers. There were 7.2 million households in 2007, up 600,000 in a decade, helping to explain the intense demand pressures in the housing market as population growth is now low.

Over the same time period, the number of one-person households rose by 380,000 to 2.5 million and this trend towards higher numbers of singles is expected to continue and to be the main source of rising household numbers in the future, with an additional 1 million by 2050. Just over a third of all households are now single person ones; a third are two or more person households without children; and a final third contain children. The dramatic rise in one-person households is having important effects on the housing market.

10% of the population is first-generation migrants and immigration has been a significant political issue in recent elections. Net immigration was running at 0.4% of the population in 2001. It then fell sharply as entry criteria were tightened and emigration actually surpassed immigration in 2004. There was a decline in emigration with the world economic crisis and more arrivals from central and eastern Europe, so that net population growth due to migration was particularly high in 2008.

The most recent overall population forecasts give widely ranging outcomes for population size by 2050, ranging from a slight fall to 15 million or a 25% rise to over 20 million, depending on the trajectory of the economy and the welfare state[15].

An ageing population is likely to begin to have a significant effect on the demographic structure from now onwards, when the share of those aged 65 or over in the population is expected to rise from 15% to 22%, which will have implications for the future types of housing required. A decline of those in the economically active age ranges is going to be associated with an ageing population. This implies fiscal adjustments with higher taxes on the economically active, which may significantly impact upon the housing system as there will be increasing pressure to cut back on less essential subsidies and tax breaks.

[15] *Netherland Statistics.*

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Factfile: Netherlands

Population (m) 2006	Annual population Growth %	Fertility rate* 2005	Years life expectancy 2005
16.4	0.3	1.7	78

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	131	131	131	135	-
Real GDP growth %	2.0	3.4	3.6	2.0	-4.3
Growth in real private consumption %	1.0	-0.3	1.7	1.3	-2.6
Inflation – consumer prices % (HICP)	1.5	1.7	1.6	1.4	0.9
Labour participation rate % (15–65 yrs old in work)	-	-	81	81	81
Employment growth	-	-	1.0	0.8	-0.9
Unemployment rate %	4.9	4.1	3.3	2.9	3.7

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	5.0	5.8	4.2	0.9	-12.6

Housing market

- Owner occupied housing: Mortgage interest relief – yes
- Capital gains exempt – yes
- Imputed rental income – no
- VAT on new dwellings: 19%
- Stamp Duty: 6%
- Property taxes as share of all taxes 2002: 5%
- Property taxes as share of GDP 2002: 2%

Taxes

Sources: Housing Statistics in the European Union 2005/6, Eurostat, OECD.

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Overview

House prices continued to drift downwards in 2009. There is no official house price index or a quality-adjusted one, so reliance has to be made on asking price measures. They show prices down by about 10% to 15% from their peak levels, with considerable variation in price falls between the major cities (Figures 9.1 and 9.2). Turnover in residential markets is much reduced. For example, the Warsaw new homes market is only turning over at 40% of the 2007 level, according to REAS. There are extensive stocks of unsold new dwellings, which are further softening prices, and developers are offering various inducements to encourage sales. New credit constraints on large mortgages have hit the luxury flat market. In existing homes markets the greatest falls have occurred amongst flats in poor locations and those built during the era of concrete panel technology.

Mortgage markets continued to expand though at a reduced rate. Much mortgage borrowing has been in foreign currencies, which intensifies the risks. However, typical mortgage repayment to income ratios are not too large, suggesting that many households still have significant financial cushions to assist them in avoiding default, and low interest rates are helping as well.

The economy helped to cushion the housing market, as it sustained diminished but still positive growth, unlike the rest of Europe. This meant that unemployment has so far not risen that much. Moreover, the decline in the housing market has been relatively moderate compared with experience elsewhere in much of the rest of central and eastern Europe.

The government has recently introduced a programme to support housing demand in face of the slump through a “family in own home” policy, which provides mortgage interest subsidies for first time buyers. It works most effectively for those buying smaller units in the existing dwellings market. Measures have also been introduced to encourage more investment in private renting (see later).

The prospect is for continued price falls in 2010, with recovery in 2011. However, there were signs that the market was bottoming out in the second half of 2009, with improved sales levels. Yet there is a lot of unsold stock to get through before vacancy rates return to equilibrium. What is more, developers have now built over 300,000 dwelling units since 2000, so that re-sales from that stock now compete directly with new build, moderating any potential for price rises. Such sales may come as echoes from the boom years. Foreign investors were active then, but have been absent for the past two years. Yet, some may still be holding onto completed properties that they would like to sell once market conditions improve. Even so, 2010 is unlikely to see major falls in prices.

The upwards shift in house prices looks as though it may be here to stay. Poland experienced sharp rises in house prices from the middle of 2005 to mid-2007, during which time prices more than doubled. At present, there does not seem to be much likelihood of a major correction back to pre-boom price levels.

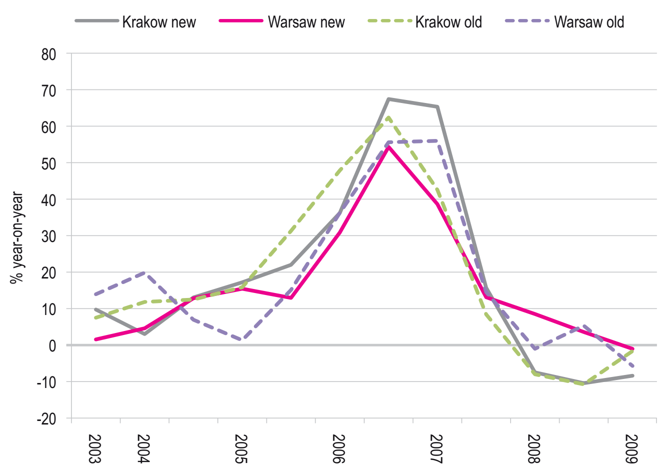

Figure 9.1: House prices, Dec 2003–Mar 2009 (asking prices)

Source: Central Bank

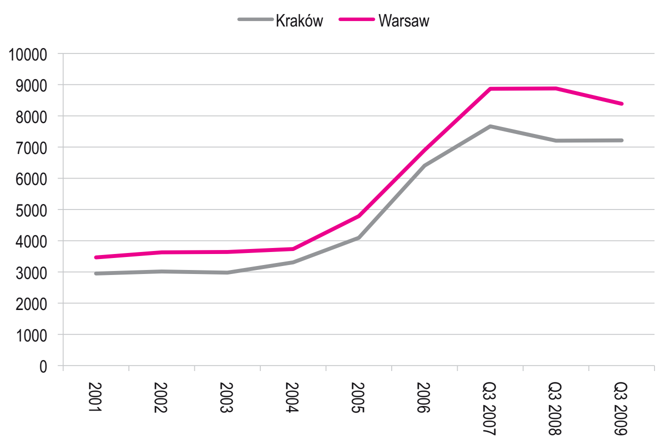

Figure 9.2: New dwelling prices, 2001–2009 (Zloty per m^2)

Source: REAS

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The housing system

The housing market is much larger than those of the other central and eastern European (CEE) countries in the EU. In addition, the housing situation in Poland brings out clearly the fact that circumstances remain in a state of transition. Traditional providers have faltered and a new private development industry has, so far, only partially been able to take up the slack. Some reforms have also not been helpful to the aim of generating long-term improvement. However, lessons are learnt, and sometimes re-learnt, so that short-term political advantage seems less of a burden on housing provision now than it was a decade ago.

There are undoubtedly still major problems with respect to satisfying housing needs across the population; in market processes; and in creating the conditions to enable sufficiently responsive supply. Yet, at the same time, there have been great strides towards a market-oriented system driven by consumer preferences and towards generating substantial investment in housing. They are gradually bearing fruit in terms of better living conditions for a growing proportion of the population. For instance, it is noticeable that the housing aspirations of younger adults are far more likely to be achieved now, despite the downturn, than was the case a decade ago and that important parts of the existing housing stock have received substantial investment in its modernisation and renovation.

The initial starting point for housing developments over the past 20 years was a difficult one that is still reflected in conditions today. Much of the existing stock is dilapidated and of poor quality and so needs replacement but most of it lies outside the scope of market processes. The vast majority of Poles cannot afford new housing. So, their potential demand is likely to take many years to satisfy. The nascent rental market is costly relative to average incomes. There is dire shortage of land – for which poor infrastructure and a lackadaisical land-use planning framework must bear much blame.

As national income per head is only 56% of the EU average, it is to be expected that housing conditions are significantly lower than in western Europe, as are many other indicators of average living standards. Even so, housing shortages are particularly acute and there is high pent up demand for improved accommodation as well as chronic absolute shortages.

The housing stock relative to population is one of the smallest in Europe and there are correspondingly high numbers of people per dwelling, averaging 2.9 in 2008[1]. Poland also has the highest share of apartment blocks in its housing stock in the EU, comprising almost two-thirds of the dwelling stock and many of them are high-rise structures, which account for almost 40% of the overall dwelling stock.

There are currently around 12 million dwellings and a crude shortage of about another 1.5 million, according to the 2002 census. Shortages are concentrated in the most economically dynamic cities. In addition, the population has a relatively young age profile, so household numbers will continue to rise over the next few years, adding further to demand pressures. Counteracting this situation has been out-migration by about 2 million people since Poland joined the EU, which has greatly reduced pressure on scarce housing resources. Despite national housing shortages, some regions have an excess of low quality dwellings and high vacancy rates.

Dwellings are quite small. The average useable floor area is 68 square metres. New apartment dwellings are often not that much larger than old ones, so tight living conditions are likely to remain for many years to come.

The housing stock is relatively young, with over half of it erected since 1970. Despite this, much of it has repair and quality problems; a legacy of past policies. Quality was sacrificed for quantity during the housing output drives of the 1970s and 1980s. There was an inappropriate use of building technologies and poor product specification, which has had knock-on effects in terms of continuous high maintenance costs and a need for the renovation of many buildings from that era. Basic repairs have been neglected over time, making conditions worse. Furthermore, many buildings lack adequate insulation, with resultant high heating costs and energy wastage. Apart from environmental concerns, energy costs are an important component of direct housing costs. Infrastructure facilities and local amenities are also sparse in many neighbourhoods. Basic dwelling amenity standards are generally good in urban areas. In rural localities, however, the picture is different. Around a quarter of rural homes lack a bathroom and/or inside toilet and 10% have no running water.

[1]Data on housing conditions from Central Statistical Office.

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Privately owned outright	Co-operative	Municipality	State	Enterprises	Other
63	24	9	1	2	1

Table 9.1: Housing tenures, 2007 (per cent, stock data)

Source: Central Statistical Office

The growth of owner occupation

The transformation of the structure of housing tenures since the 1980s has ostensibly not been as great as in some other previously centrally planned economies for a mixture of political and practical reasons associated with the institutional framework of property ownership. By 2008, 63% of dwellings were fully-owned by private individuals, mainly as owner occupiers, but this seems a fairly limited change when it is realised that 48% were already privately owned in 1988. However, the apparently limited role of dwelling privatisation relates to the institutional nature of real estate ownership in Poland.

As can be seen in Table 9.1, the second largest tenure is co-operative ownership; then successively in terms of the scale housing provided: local authorities; the state; firms providing housing for their workforces and retirees; and a small other category. The latter includes some recent social housing institutions.

The seemingly low share of private ownership is due to the ways in which privatisation has been taking place. There have been sales of individual apartments in building structures owned by municipalities, employers and co-operatives. But most sales to tenants in co-operatives have been of tradable rights-of-occupancy, similar to those in Scandinavia, as well as outright sales on a condominium basis with the co-operative retaining administrative functions. So, in one block of apartments there can be three different types of property relation: tenant, right-of-occupancy and condominium. Overall, if the different types of property rights corresponding to private ownership in the generally understood sense of the word are added together, the private ownership rate rises to over 75%. This is not dissimilar to the experience in the other central and eastern European countries.

Recently, the law has been changed to allow full owner occupancy rights in place of tradable rights in co-operative ownership. However, this change is unlikely to enhance the supply of apartments much, according to a central bank analysis. Such apartments are mostly of low standard and their owners are usually low-income and so retain the apartments outside of market relations in order to satisfy their own housing needs. In the absence of a clear market, their values as assets are low and hard to realise.

Local government only originates from 1991, so its experience of administering housing is limited. Councils' housing stocks are based on decentralisations of previous state housing. Estates are heavily loss-making, given low rents and high outgoings in terms of heating, other services and maintenance. In consequence, most local authorities are keen to sell off of as much housing as they can expediently do. Council housing is geographically concentrated and in some localities municipal tenants form influential voting blocs.

Housing co-operatives can be huge organisations of up to 100,000 members, all of them set up under the aegis of the old regime. Nominally, their boards are voted for by members but turnout is low and typically little notice is taken of memberships in the larger organisations. To date, there have been few conflicts between tenants and new apartment owners over repair costs to buildings. This is partly because the building structure is still usually owned by a third party (i.e. the co-operative or municipality) and also because everyone typically has only a low income and generally prefers the minimum necessary expenditure. It is unclear how major renovations could take place to such structures without significant subsidy, given the incomes and mixed incentives of occupants.

Overall, there is a huge backlog of work required on existing dwellings and amenity improvements in local neighbourhoods. Over 60% of the stock was in need of significant repair and over 10% required major renovation, according to the 2002 census. Though the repairs situation has improved in recent years, the aggregate result remains a hugely expensive backlog of work requiring many years to overcome. Furthermore, the economic life of many currently 20 to 30 year old buildings could turn out to be shorter than originally expected, because the costs of renovating them are too high relative to their usefulness. Given current housing shortages, there is little chance that new building will lead to significant replacement of the existing stock in the near future.

% households	Total	Warsaw	Urban	Rural	Starters	Young families
Owner occupied	66	49	56	88	44	50
Public rental	14	21	20	2	32	23
Private rental	17	28	22	6	24	27
Other	3	3	2	4	-	-

Table 9.2: The household tenure mix

Note: 2002 survey. Starters – aged 16-29 years; Young families – aged 30-44 with at least 1 child.
Source: World Bank

Private renting

Formal private renting is not a category that appears within the housing stock statistics shown in Table 9.2 and most private ownership is commonly regarded as for owner occupation. A 2002 survey by a World Bank research team, relying on household interview information, suggests that the size of the privately rented sector might be significantly higher than is commonly believed[2]. The household survey approach inevitably leads to approximate results but it suggests that around a quarter of all households in the larger cities live in private rental accommodation and that around a quarter of younger households are private tenants.

Many landlords formally declare their property holdings and pay taxes on rents net of costs, though informal letting is still common. The regulatory situation for investors is not ideal, with a variety of rent control measures outside of the luxury sector, which typically caters to foreigners. The terms of the Tenant Protection Act discourage investment and the courts are reluctant to enforce eviction on non-paying tenants. Yet this does not seem to have halted a thriving urban rental market. With the slowdown in housing markets over the past couple of years, some of those who could not sell have rented out their properties instead. This has expanded rental supply and lowered rents.

The situation of investors will be improved with the introduction of the measures in the “Law on Occasional Rental”. Under its stipulations, income tax on rents will be lowered to 8.5% and the position of landlords in relation to tenants will be strengthened, reversing some of the effects of the earlier Tenant Protection Act.

Barriers to change

Property rights may be confusing, uncertain or unenforced. For example, much older housing was expropriated by the state in the 1940s, in many cases without adequate legal foundation. Claims for compensation or restitution of building ownership as a result are currently going slowly through the legal process, holding back investment and repairs in the contested dwellings, though these form only a small part of the overall housing stock.

Another issue concerns a new planning regime. It has been introduced in major cities, like Warsaw, making the old plans redundant as they no longer have any legal status. However, new plans have not been formulated for most areas of cities so far (only a minority of Warsaw has new plans, for instance). This means that all development is technically frozen until the new local plans are drawn up and ratified; unless special micro-local plans are made in relationship to specific developments as they arise. This special procedure is time-consuming; raises development costs; directs development to localities where such procedures are easier; and generally is an inefficient and piecemeal way of planning urban land uses.

Such constraints encouraged developers to concentrate on housing for the upper-to-middle sectors and in central locations because they can more easily bear the additional overheads. What is more, local authorities in those areas are used to dealing with development applications and so are more able to process them. The worst hit parts of the market are consequently likely to be at the lower end. However, the current crisis is highlighting the oversupply of new upper market properties and the volatility of that market, so developers are keen to move downmarket which will put pressure on local authorities to make sure more land is available.

[2] *Rental Choice and Housing Policy Realignment in Transition, World Bank, 2005.*

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Enforcement of existing regulations is another area of difficulty. Many building renovations have not conformed to regulations (up to 60% of them, according to informed estimates). Some have led to the illegal eviction of existing tenants, but there is little prospect of restitution for the tenant or, possibly, for the previous property owner who could have commanded a much higher price with vacant possession.

Policy-making itself may send out inappropriate signals and lead to failure to achieve objectives. An example of confused political outcomes relates to the reform of rents across the whole range of non-profit landlords. They were supposed to move from the mid-1990s towards more realistic levels, which would have led both to a more efficient use of space and provided higher incomes to housing institutions, enabling them to spend considerably more money on improving poor existing housing conditions and removing the need for continued municipal subsidy of loss-making organisations. Laws were duly passed that enabled rents to rise. However, political pressures have generally meant that co-operative and municipal rents remain low[3].

Nevertheless, a whole variety of central government subsidies to housing have been pared away over the past decade, as the responsibility for housing provision has passed to private initiative and local authorities. By 2004, the only remaining large, long-term, central government subsidies, apart from housing-related tax reliefs, were associated with mortgage subsidies, guarantees on housing savings schemes, and for social housing. Municipalities determine their own levels of housing allowance support for low income households, funded from local taxpayers. This framework leads to considerable cross-local authority variation in them.

The interest costs of housing loans can be deducted from income tax assessments on a limited and capped basis. In addition, part of the costs of housing renovation and modernisation can be offset against income taxes for the expenditures made by both owners and tenants[4]. However, the relevance of tax reliefs is currently less than in many other European countries because of relatively low income tax rates. Most people now pay 18% of their gross incomes in tax. The income tax system was reformed in 2009, with only two brackets remaining: both at comparatively low rates of 18% and 32%. This leaves the country with one of the lowest top marginal tax rates in Europe. There are no local property taxes but stamp duties exist on transactions.

Poland's membership of the EU has altered the incidence of VAT with respect to housing. A reduced rate of 7% applies to most housing-related construction activity (new build, renovation, etc), but construction materials are subject to a 22% VAT rate. This higher rate also applies to the most spacious of new properties but all apartments up to 120 square metres and houses of up to 200 square metres are designated as having a social purpose and under EU rules therefore continue to be subject to the 7% rate.

One of the difficulties of housing and mortgage transactions is the time it takes to register them with regional courts, which can run to many months. Electronic systems are being introduced to speed up the process. Unfortunately, implementation is slow, so that delays in parts of the country remain and will do so for some time to come.

Housebuilding

Housebuilding levels doubled in the 2000s to reach 165,000 dwellings in 2008 (Figure 9.3), although these levels are far below those necessary to give all households good quality accommodation. Most new housebuilding is now for the private sector. Social housebuilding has dwindled to a very small level, as seen in the 'other' category in Figure 9.3. Moreover, most housebuilding by housing co-operatives is now apartments for sale.

Professional development firms have grown from a small scale activity at the turn of the century to producing 40% of all output in 2008 and 46% in 2009, mainly through the building of apartments.

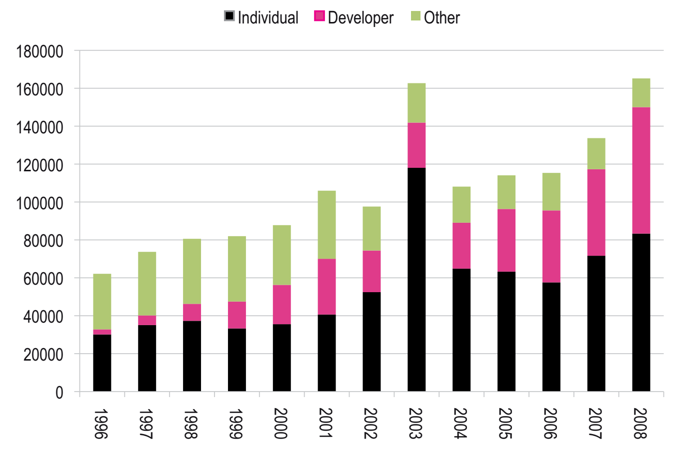

Figure 9.3: Housing output, 1996–2008

Note: The 2003 housebuilding figure is exaggerated by regulatory changes which encouraged owners of undeclared dwellings to register them in that year; correspondingly data in earlier years are under-recorded.
Source: Central Statistical Office

[3] *Muziol-Weclawowicz & Oracz 'Rents in Polis Social Housing', ENHR 2004.*
[4] *Ministry of Finance.*

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The typical development model in recent years has been for many sales to be off-plan and building only commences when the developer raises sufficient purchaser deposits. If insufficient purchasers come forward to make a scheme viable, outstanding deposits should be returned. The loss of purchaser deposits was an issue the last time the market slowed in the early 2000s. It remains to be seen whether such problems arise again in the current downturn. But escrow accounts, which could protect purchasers, do not exist. Mortgage lenders have tightened up on their lending criteria since the world financial crisis and now frown on off-plan purchase because of the default risks.

Within the private sector, small-scale building for private individuals still predominates and represents half of all output (Figure 9.3). It mainly consists of private individuals having single-family dwellings erected on individual plots they have bought or already own. These buildings are generally for own-use though they may be sold. This type of procurement is much easier in suburban and rural areas and smaller towns and the build quality is variable. A typical suburban house has 120 to 200 square metres net floor space, a ground floor and a usable attic. There are now a number of substantial suburbs of such dwellings around the country's major cities.

Housebuilding by co-operatives has declined significantly in recent years. Much of their output since the early 1990s has been for the private market, with sales a useful source of income for them. Output has continued to fall with 8,600 co-operative completions in 2008. Co-operatives have legal problems with raising finance for development. They produced only 5% of new dwellings in 2008, down from a third at the turn of the century. Municipal and enterprise housebuilding is now less than 3,000 units a year. Another three thousand or so social homes are provided under other social housing arrangements and their output has been declining in recent years as political support for them has also waned.

The finance of new residential development requires substantial upfront funding for land, infrastructure and construction. This need is met through bank finance as well as purchaser deposits. A few years ago, banks were wary of lending to developers because of the risks involved but relaxed their lending criteria as the housing boom took off. More recently, since the onset of the financial crisis development credit has become hard to find again.

The two main developers in Warsaw are local companies but European firms have played a part in the growth of the sector as well, such as the Swedish firm, Skanska, Bouygues from France and several developers with a UK capital base. Irish and Spanish firms have also been active. Some foreign firms initially pitched their products into a luxury sector that is too expensive for the local market. Most new building instead is now of a smaller size. Until the slowdown, it consisted of semi-finished apartment shells but now harder times are forcing developers to upgrade their market offers. A typical 1 bed unit has a floor area of 45-55 square metres and a three room one is in the 70-80 square metres range.

There was a move towards greater emphasis on building near urban cores in the 2000s as more land became available. In Warsaw, several high rise developments have been built in the city centre. But with growing oversupply in the middle to upper sub-markets, a move downmarket to more mass, typically suburban, housing sectors is likely to occur in the upswing, if planning and infrastructure constraints can be overcome.

The cooling of the market did not initially lead to a fall in completions, as sites continued to be built out. However, starts were 20% lower in 2009 and permits almost a quarter lower than in 2008[5]. The biggest falls were for developers. Their starts fell by 38% and permits by 39% as they retrenched in the face of unsold completed dwellings.

[5]To end November. Central Statistical Office.

Macroeconomic influences

The economy expanded rapidly between 2004 and 2008, driven by booming domestic demand, and a good pace continued in 2008 with growth at over 5%[6]. The economic crisis slowed down growth in 2009 but, uniquely in the EU, it remained positive at 1.4%, and is expected to pick up further in 2010.

The public sector deficit has been growing as a result of the downturn and associated stimulus measures and reached 6% of GDP in 2009 and it is expected to rise for another couple of years. Inflation rose significantly in 2008 to 4% and only moderated slightly in 2009. Inflationary concerns and a weak fiscal stance encouraged the central bank to raise interest rates four times in 2007 and 2008 but the slowing economy led to significant subsequent reductions in general price increases.

High unemployment has been a long-term characteristic of the economy. It was running at almost a fifth of the workforce prior to 2004 but with a booming economy it then fell to 7% in 2008. It is now drifting up again and expected to remain at around 10% for some time to come. The country has a relatively low share of people of working age in employment with only 63% in work. This restricts the number of people in many families capable of contributing to housing costs.

Social security payments are limited, so that widespread poverty exists. Large numbers of these households are concentrated in un-privatised apartment blocks and can afford to pay little or nothing for their housing in the absence of housing allowances[7].

New households face housing affordability difficulties as house price rises have substantially outstripped increases in earnings and any subsequent downward price adjustment has been far less than previous rises. The outcome is that affordability declined considerably when measured in terms of price-to-income ratios between 2005 and 2008 and has not improved much since then. Purchase remains a distant prospect for the majority of households.

Mortgage market influences

The mortgage market has been growing rapidly. It rose 35-fold between 2000 and 2009 in nominal zloty terms. Mortgage lending continued to grow, even after the advent of the credit crunch. In the peak summer period from April to September, overall household credit expanded by 14% in 2008 but after that a slowing did occur and growth had fallen to 6% in the summer 2009 (Figure 9.4). The slowdown was due to supply-side constraints as well as lower demand. Banks have tightened up mortgage lending criteria and have raised spreads, and most have stopped lending in foreign currencies.

Despite the recent period of rapid growth, the Polish mortgage market is a relatively small one by western European standards, having been virtually non-existent until 2000. The mortgage debt to GDP ratio was only 12% in 2008, according to the European Mortgage Federation. Furthermore, many transactions still occur without recourse to mortgage lending, especially in the second-hand market – about which relatively little is known – and in the private individual new build sector.

Reasons why the mortgage market took so long to take off relate to inflation. In 1997 and 1998, nominal mortgage interest rates were 25%, imposing high repayment costs in the early years of a mortgage, and they were still in double figures into the early 2000s. Such high rates were a disincentive to borrowing, although indexation was widespread from the late 1990s but complex to understand. High lending rates were caused by the large spreads on mortgages demanded by financial intermediaries as well as by the general level of nominal interest rates. Improved efficiency, greater competition in the mortgage market and falling interest rates then led to the take-off of mortgages.

Mortgages are generally offered by commercial banks, issuing variable loans at short-term interest rates plus a spread. However, a full range of mortgage products is on offer, with varying terms during which interest rates are fixed. Central bank surveys show that half of all loans in 2008 were associated with loan-to-value ratios of over 80%. But typically the loan service to net income burden was below 22%, so that most borrowers have a reasonable income cushion if their mortgage costs rise. However, there is small group of borrowers that is distinctly more vulnerable.

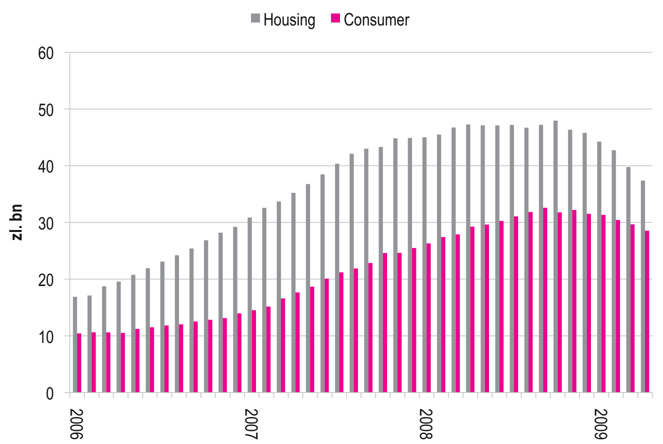

Figure 9.4: Household lending, 2006–2009

Year-on-year increases in loans
Source: Polish Central Bank

[6]OECD.
[7]Large Housing Estates in Poland, Węcławowicz, Kozłowski and Bajek, RESTATE, Utrecht University, 2003.

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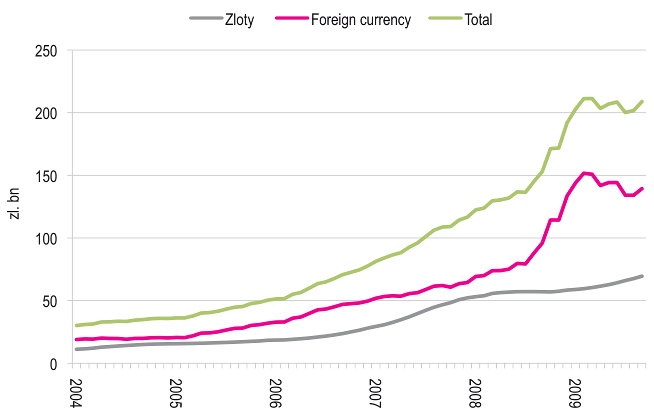

Figure 9.5: Outstanding mortgage loans, 2004–2009

Source: Central Bank

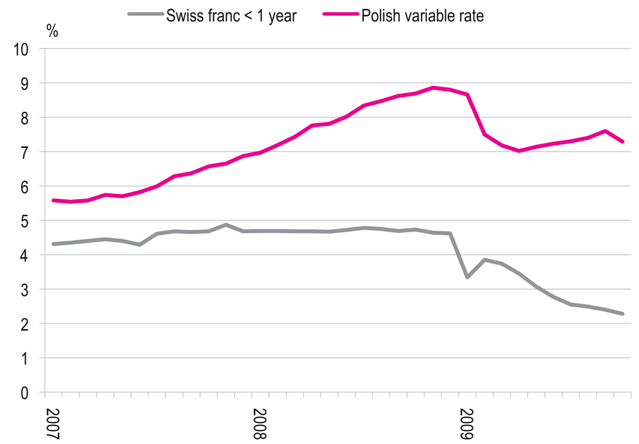

Figure 9.6: New housing loan interest rates, 2007–2009

Domestic currency and Swiss franc denominated
Source: Central Bank

Foreign currency lending accounts for a high proportion of outstanding loans and it had been the fastest growing part of the mortgage market until the financial crisis brought new FX lending to a virtual halt (Figure 9.4). Two-thirds of outstanding housing loans were denominated in foreign currencies in October 2009.

Much of the borrowing had been in Swiss francs because of the attractiveness of the interest rates on offer. Loan costs in that currency hardly changed in the years prior to 2009; whereas those for zloty-denominated loans increased as the central bank tightened monetary policy (Figure 9.5). Swiss franc dominated loans have experienced substantial interest rate falls since late 2008, offsetting currency exchange rate shifts. However, this is of little benefit to new borrowers who now have only limited access to non-zloty loans.

As household earnings are denominated in Polish currency, borrowers of foreign currency denominated mortgages face significant exchange rate risks, especially as the exchange rate began to move against the zloty in 2008. (This decline in the exchange rate has to be taken into account when looking at the changing value of FX loans shown in domestic currency terms in figure 9.5). Exchange rate volatility remains a significant risk for the housing market. If the currency depreciates, the costs of two-thirds of outstanding mortgages will rise, unless there is an offsetting interest rate effect, as occurred in 2008/9, but such a fortuitous event is unlikely to occur again, as international interest rates are more likely to rise than fall.

A broking industry has developed as intermediaries and there is some concern over its lack of regulation in the country where few people have much experience of mortgage finance.

Policy encouraged the development of a mortgage bank system, raising funds on capital markets for lending to consumers on a long-term fixed interest basis. But, to date, it still represents a small fragment of the mortgage market. In addition, there is a state supported housing savings scheme similar to that of the Bausparkassen in Germany. Low interest rates on savings are matched by low lending rates on loans in a mutual-support type of way. However, the expected flood of higher income groups to such schemes did not materialise and the funds remain minor players in the financial system.

Demographic influences

Population pressures, which are currently strong, are forecast to abate. The population is expected to broadly stabilise until 2020 and then fall quite substantially - by over 5 million - in the subsequent decades up to 2050 because of the low birth rate and emigration. The population will also age, so that 30% of people will be 65 or older by 2050 and the dependency ratio of those over 65 to those of working age will rise from a current level of 19% to a substantial 56% in 2050.

Yet, even so, demographic pressures are currently pushing up housing demand strongly as there remains a surge of younger people entering the initial years of household formation. Offsetting this is the fact that many young Poles have moved elsewhere in Europe in search of higher living standards. Internal migration to the economically strong major cities away from rural and declining areas is putting pressure on housing provision in such localities.

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Factfile: Poland

Population (m) 2007	Annual population Growth %, 2007	Fertility rate* 2006	Years life expectancy 2006
38.1	0	1.3	71

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	51	52	54	58	-
Real GDP growth %	3.6	6.2	6.8	5.0	1.4
Growth in real private consumption %	2.1	5.0	4.9	5.9	3.2
Inflation – consumer prices % (HICP)*	2.2	1.3	2.5	4.2	3.5
Labour participation rate % (15–65 yrs old in work)	-	-	63	64	64
Employment growth	-	-	4.4	3.7	0.3
Unemployment rate %	17.7	13.8	9.6	7.1	8.4

Economic

Sources: Eurostat, OECD.

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Overview

The housing market downturn continued during 2009. There was some evidence that the decline might be bottoming out towards the end of the year, though the housing market and the wider economy still face substantial problems. So, it is by no means certain that the end of the housing market downturn has actually been reached.

The adverse market conditions have been feeding into official price indices. There is uncertainty and debate about the extent of the price falls that have occurred, especially in new build. As a result, it is worth spending a little more time than usual in the other country chapters to go through the different indices.

There are two official indices. The most long-lasting is the Housing Ministry index based on the property registry, which means that it significantly lags market transactions. It recorded an 8% year-on-year fall in q3 2009 (Figure 10.1) and a 10% decline since the 2007 price peak (and a 1% fall on the previous quarter). There are also some recent indices from the national statistics institute, INE, based on data from notaries.

INE indices on new and existing house prices indicate divergent outcomes. The results from the new-build housing index are surprising and may reflect issues with the nature of the collected data, because the price series shows virtually no change since the end of the boom, which seems at variance with the continued existence of very large stocks of unsold new dwellings (with more in the pipeline), popular commentary and the heavy discounting currently being undertaken by the banks and major developers holding stocks of completed housing. (However, the efficacy of discounts as a measure of actual house price change is questionable, as they are marketing devices that tend not to be based on current market values.) As a result, only the existing homes series is shown in Figure 10.1.

By contrast, the INE series for existing homes shows marked annual house price falls of 11% in q2 2009 and a decline from the 2007 peak of 16% (Figure 10.1). Other price indices also highlight significant price falls. But they are not that out of line with most of the official indices. Fotocasa's house price index recorded a 10% price fall in the year to November 2009, and a 20% decline from the peak. Tinsa's index, based on valuations, showed the most modest decline at 6.6% year-on-year to November 2009, with an overall 11% fall from the peak.

Overall, an approximation of a 15% price fall from the peak of the boom would seem to be a reasonable interpretation of the prevailing house price data. Taking account of general price inflation, this suggests a roughly 20% real decline in values. There are undoubtedly substantial locational and dwelling type variations around this average national number. This will be due to differences in both local speeds of adjustment and the amount of house price change generated by revised relationships between local demand and supply.

The country had one of the biggest housing market booms in Europe up to 2007. Property prices increased by 2.2 times in real terms between 1996 and 2006; housebuilding rose to record heights; and mortgage debt increased dramatically. Housing investment alone was 8% of GDP in 2006 and construction as a whole, much of it related to real estate, about 13% of GDP. Average household debt reached 130% of personal disposable income in 2007 – three-quarters of it related to mortgages – and in 2009 was still at 125%, although falling interest rates had lowered the current burden of outgoings[1].

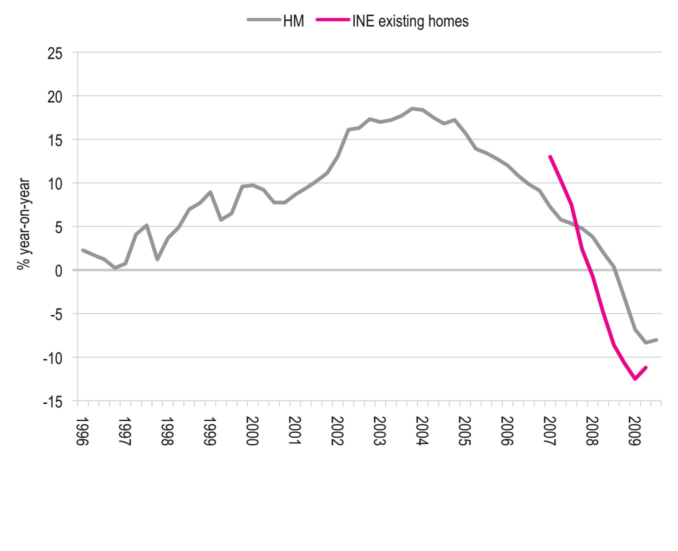

Figure 10.1: House price change, 1996–2009

Note: HM = House price data from Housing Ministry;
INE = Existing house price data from National Statistics Institute
Source: Housing Ministry, INE

[1]*Bank of Spain.*

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The extent of the market slowdown can be seen clearly in transactions data. The number of registered sales had peaked in 2006, some time before the onset of the financial crisis. But by the third quarter 2009, recorded sales were 40% less than that peak (Figure 10.2). Though it is hard to measure the vacancy overhang, overall unsold and soon to be completed dwellings are believed to amount to over a million units; a proportion of which are holiday homes but many are primary residences.

Housebuilding tells a similar story of decline but from extraordinary peaks in the final years of the boom. Almost 600,000 dwellings were completed in 2006, which works out to be around 13 dwellings per 1,000 Spanish people - many times higher than the volumes most other European countries were building in their housing market boom years.

Since then, output has been sliding. However, completions did not start to fall until late summer 2008 and then surprisingly levelled out in 2009 (Figure 10.3). This may be due to statistical issues related to when a completion is recorded, but also shows the time it takes to build out developments and the incentive for even heavily loss-making developers to keep on building if they can raise sufficient short-term loan finance and sales revenue to put off the threatened day of failure.

Housing starts (issued permits) reacted more quickly to changed market conditions. They had fallen to around only a fifth of their previous peak level by 2009 but, like completions, they flattened out in 2009 as well. Even at that reduced level, they were still significantly higher on a per capita basis than the building troughs of other stricken European countries, such as the UK. It may be reasonable to assume in consequence that the flow of new supply still probably outpaces much reduced housing demand.

There is an issue with the housing output data, in that completions remain far higher than starts to a degree that building time lags are unlikely to explain adequately. The data suggest that over 360,000 dwellings per annum are being completed over two years after a major turnaround in the housing market. Typically, the expectation in a severe housing market crisis is that developers would mothball sites with long development trajectories, either voluntarily or involuntarily through pressures from creditors. It may be that case that many developers, or their financiers in cases of insolvency, are being slow to declare completions due to the huge number of vacant dwellings already on the market. Whatever the true cause of the discrepancy, the supply-side does not yet seem to have fully adjusted to changed market conditions.

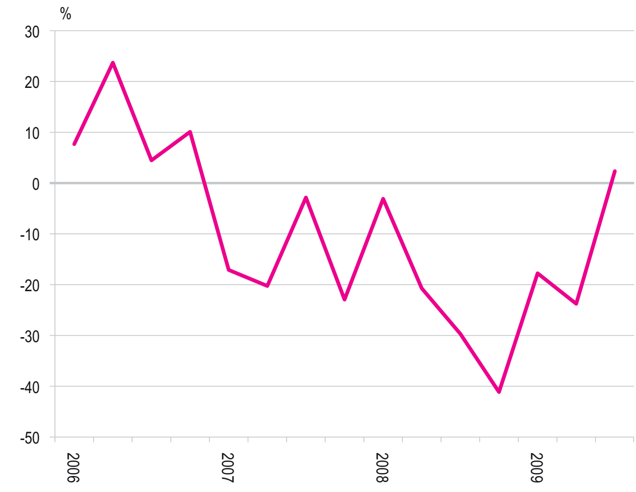

Figure 10.2: Annual changes in housing transactions, 2006–2009

Source: Housing Ministry

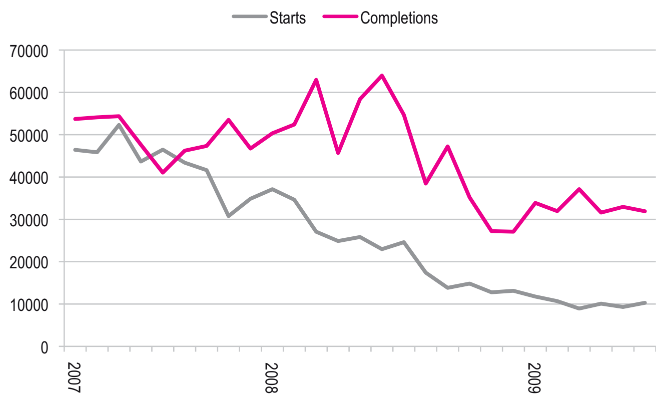

Figure 10.3: Housing starts and completions, Apr 2007–Jun 2009

Source: Housing Ministry

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A continuing threat to the housing market is the overhang of unsold property that is currently being kept off the market by the behaviour of financial institutions. The cause of this recalcitrance may lie in the financial system, because banks have incentives to be slow in foreclosing on problem real estate development loans and to hold on to completed properties they have on their books acquired as collateral for defaulting loans. High loan volumes were granted to the real estate development sector in the boom years (to finance land, developments underway, and finished housing). Although the market has obviously declined since then, the current true valuations of those heterogeneous loans and the underlying real estate assets can be argued to be subject to uncertainty, since there are no organised secondary markets for them. Accordingly, the practice has been adopted by lenders of a progressive recognition of impairment in which the actual loss in relation to amortised cost is posted in accounts only gradually over time as further evidence clarifies true values[2]. Of course, banks can only do this if the loans and the real assets backing them are held rather than sold, because then the values would become certain, and the practice is kept within the limits of acceptability to the supervisory authorities, which have been quite accommodating in this respect.

The outcome of such balance sheet beneficial practices is that many unsold properties have been kept off the market by banks and developers, which has helped to moderate price falls. This experience has been distinctive from many other countries; as, for example, with the rapid foreclosure processes associated with defaulting owner occupiers and developers in US markets that triggered so much of their downward trajectory. It has helped to avoid a similar reinforcing downward market spiral in Spain, but sustained recovery is unlikely to occur until many currently unsold properties are absorbed by the market. In any case, as house price falls become clear and the fragility of developers' balance sheets become increasingly obvious, the process of gradual write-downs begins to find its limits. A consequence may be quite a substantial flood of properties onto the market in the near future. Even if that flow can be regulated, such sales are likely to continue to put downward pressure on house prices for some time to come, with potentially adverse effects on price expectations.

The government has introduced some fiscal measures to revive the economy and offset the decline in the housing market. For example, a temporary measure has been introduced to enable the unemployed to roll-up interest payments rather than default and public expenditure on construction activity has been increased. However, the scale of the downswing is such that any actions are only likely to moderate decline.

Some basic long-term drivers of housing demand are still strong. Acute housing shortages continue, despite all the building, because of previous low housing standards, demographic pressures and long-term rises in living standards. There have been high levels of immigration, raising the population by over 4 million in recent years, which has put further pressure on housing. But such factors in themselves count for little in an economic depression.

Housing markets are invariably heterogeneous locationally and by dwelling type and Spain's diverse geography highlights such differences strongly. Consequently, the scale of the price changes that have occurred and the risks of further downward adjustments vary across the country and by market segment. Nationally, some commentators argue that prices still have a long way to fall. For example, the leading consultancy Aguirre Newman argues that prices have to fall by nearly 30% more to get back to long-term affordability ratios[3]. Currently, low interest rates have improved affordability but they will increase in line with developments in the euro zone economy as a whole, rather than Spain alone, and unemployment is rising. House price forecasting on the basis of mean reversion to simple ratios was criticised in Chapter 1. Even so, clear risks remain with regard to the current price levels, despite nascent signs of housing market recovery.

[2] *Financial Stability Report, Bank of Spain.*
[3] *Aguirre Newman, Informe de coyuntura global del mercado inmobiliario Español 2009.*

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The housing system

Despite having the highest overall number of dwellings per 1,000 inhabitants in the EU, housing conditions for many still remain some of the most crowded in the EU with 3.0 people on average per occupied dwelling. This cramped lifestyle reflects cultural factors as well housing shortages, as several generations of families may live together in dense urban accommodation. The number of rooms per dwelling is quite high by average EU standards, yet rooms tend to be small with the usable floor area of dwellings towards the bottom of the EU rankings.

Much housing is in multi-dwelling units, especially in the large urban areas. In fact, the country has the second smallest share of single-family structures in the EU at only 31% of the stock of primary residences[4]. Much of the stock, however, is relatively new - with a third being built in the last 25 years, compared to only 14% of Germany's and 10% of Italy's housing stocks[5].

There is also a high propensity to aspire to own a second home in the countryside or on the coast: over a fifth of households own one. This helps to make crowded urban conditions more tolerable for those that can afford it. There is also a high level of second homeownership by foreign nationals and many Europeans retire to Spain as well.

Owner occupation and taxation

Most housing is owner occupied. Spain has one of the highest levels of homeownership in the EU, at 82% in the last census[6]. Tax breaks for homeownership are significant, including mortgage interest and capital repayment income tax relief and tax breaks on housing savings schemes, which altogether are capped to generate maximum potential tax savings of around €1,400 a year. Imputed owner occupier rents are not taxed nor are capital gains if the proceeds are reinvested in another main residence. There is a wealth tax, with a rate rising from 0.2% to 2.5% for net assets worth more than €10.7m, with an initial exemption of approximately €150,000. Landlords are also offered tax breaks which effectively remove rental income from taxation[7]. Such tax breaks encourage investing in housing in general and favour owner occupation more than renting. Their existence helped to fuel the recent housing boom.

New housing pays VAT at a 7% reduced rate. There is also a turnover tax on purchases of existing dwellings, set by regional authorities at the same rate as the VAT on new property.

Second homes and vacant dwellings

14% of the stock was second homes in 2001 – and the share will probably have grown since then. Of the overall stock of 19 million dwellings, a high proportion are vacant - 21% in 2004 - often because they are either extremely run down or in the more remote locations that are losing population to the growth areas. However, low returns and restrictive regulations in the rental market are also encouraging investors to leave their properties vacant, though it is difficult to evaluate how much of the vacancy rate arises from this factor.

Vacancies themselves are not carefully enumerated, except at times of the population census, so there is no clear way of knowing what short-term variations in vacancy rates are and where they are greatest. Nevertheless, it is likely that around a third of the stock of existing dwellings is not in the main prime residence market, one of the highest shares in the EU. With a substantial amount of new building produced for second or retirement residences, the apparent supply situation in the primary residence market at the national level is significantly less than it first appears.

In general, the wealth holdings of Spanish households are highly concentrated in real estate (mainly housing) and the share rose significantly during the 2000s, because of the increase in house prices. There is an interesting breakdown of real estate wealth, with 59% of it derived from main residences and 21% in other real estate, with the latter indicating the extent of second homes and vacant holdings as well as the existence of the privately rented and non-housing sectors. 70% of households have wealth from only their main residence or have no real estate holdings at all[8].

[4] *Housing Statistics in the EU 2005/6.*
[5] *Housing Statistics in the EU 2005/6.*
[6] *Census 2001.*
[7] *OECD Country Report Spain, 2007.*
[8] *Central Bank estimates 2005.*

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Subsidised housebuilding

Some newly-built owner occupied housing is given subsidies in the form of reduced interest on loans via means-tested schemes. According to the Housing Ministry, housing subsidies in recent years helped to finance about 60,000 new units a year and another 50,000 renovations. The 2009-2012 state housing and renovation plan allocated €15bn towards this programme until 2010, a significant increase, and aimed to fund stock conversions of 3,000 rental dwellings. A further €8bn of funds was allocated for local area improvements, energy efficiency, housing rehabilitation and other urban schemes.

Supply-side subsidies that focus on low-income owner occupation have been criticised as inefficient and ineffective by organisations like the OECD. Households are eligible for the subsidised dwellings on their current incomes, which may only be temporarily low, and they can sell at market prices shortly afterwards; the scheme may be mis-used for secondary residences; most of the housing is provided in the private market and developers often do not find the subsidies attractive enough; the cost to the state is high; and the location of dwellings built under such schemes is unlikely to be in the areas of greatest need.

A recent Land Law goes much further than the previous arrangements and specifies that 25% of all new houses to be built should be subsidised ones, which raises the building costs of free market dwellings for developers at a time when profitability is being severely eroded. In addition, developers have to give between 5% and 15% of their land when it is classified as developable (i.e. rezoned) to the municipality (instead of a previous fixed 10%). The appropriated land is used for public purposes – roads, schools, etc – but municipalities can also sell it if they wish. The ability to sell gives municipalities an incentive to zone land for development, because they gain revenue when they do so.

The fiscal incentive to rezone land for housebuilding is now weakened under the new Land Law. Under its terms, municipally-acquired land has to be sold for subsidised housing and, so, it will command lower than free market prices and local authorities will earn lower incomes when they rezone land. The full implications of the changes will only become clear in the recovery.

Renting

At only 11% of all housing in 2001, renting makes up one of the smallest shares in Europe. Virtually all of it, furthermore, is in the private sector with only 2% of rental dwellings classified as social. Public sector and non-profit provided social housing of the type common in many other EU countries hardly exists.

The rental market is concentrated in a few main cities, such as Madrid and Barcelona. It has been in long historical decline in the face of rent controls and pro-ownership subsidies, tax reliefs and consumer preferences. Rent increases have been limited in recent years, despite the scale of current general housing shortages. Returns are consequently generally low with the exception of windfall capital gains from sales of vacant properties to homeowners or investors.

Recent policy has tried to revive the tenure in order to meet the housing demands of mobile and single person households and those who cannot afford homeownership, such as low income and migrant families. Controls on rents in new tenancies were liberalised in 1985 – though leases still run for a minimum of five years with rents rising only by inflation during them, and landlords face legal difficulties over non-payment of rents and other breaches of lease terms. Court procedures for eviction may take a year or more and reforms to the process have stalled. Tenancies taken out prior to 1985 still have security of tenure and low rents, which makes this a small return, poorly maintained sector.

The government has announced that it wishes to double the relative size of the rental sector in a drive to improve the supply of affordable housing. Tax incentives to invest have been improved recently to cover purchase and renovation. Rent allowances for low income families have been raised but last only for a maximum period of two years.

A new scheme provides subsidies for housing to rent if it remains in the rental sector for at least ten years. Tenants would have the option to purchase properties later with some claw back of the rents they have paid.

Housebuilding

Annual housebuilding rates more than trebled during the housing boom (Figure 10.4). The scale of the recent housing boom is remarkable for a country of Spain's size. In 2006, the number of housing completions per 1,000 population was almost 15, which is 4 to 5 times the figure common in most advanced European economies, and the multiples over the rest of Europe were still huge in 2009, despite several years of decline. The housebuilding downturn probably still has some way to go. Yet, trend per capita building rates are likely to stay at a higher level than in many other European countries because of demographic and housing quality pressures and due to the importance of the second and retirement homes markets.

Output peaked in 2006, partly because of the introduction of a new building code which encouraged developers to bring forward projects. The subsequent fall as the market slowed was muted for over a year until the second half of 2008 as projects were built out and as the world economic crisis intensified. Given the fact that blocks of apartments have to be built out once started, it takes some time to cut back output. Once the finance is in place and contracts are signed, developers may prefer to hope for the best, that market conditions will improve by the time their projects are completed, rather than incur substantial upfront losses in cancellation clauses and the certainty of being unable to repay debts. Banks may also be reluctant to call in loans, as discussed earlier, so projects proceeded even though they eventually turned out to be heavily loss making and a drag on the market. Such projects also helped to push a number of large and many small developers into liquidation.

The impact of land and planning policy on the amount of housebuilding

As was noted earlier, building land is made available in the planning system via a zoning process that designates and periodically redesignates land into zones of urban, developable and protected uses. In the decentralised political structure of Spain, there is no central co-ordination of land-use planning, so planning policies vary between regions and municipalities and delays can be extensive. Developers have to implement infrastructure works themselves and it can take years to win planning approval.

Despite the variability, local government generally responds to the land release incentives that local government finance and the planning system give them. This has helped to propel housebuilding to such high levels. There are now concerns about the environmental degradation that has been associated with the massive amount of housebuilding that has taken place.

The conditions under which building permits are issued has been recently tightened and some coastal developments built without permits are being demolished.

An important element in local government decision-making processes over residential land availability is the fact that real estate is the major source of municipal income. During the boom, local public income was substantial from sales of land appropriated during zoning processes, plus income from the taxes on land sales, and also from other property value based local taxes. Given the past significance of development-based local government finance, the new era with changed housing market conditions and land policies is going to lead to far lower levels of local government income from real estate, which may damage future urban development plans.

Moreover, though this local authority income factor generally acted as a stimulus to land release during booms, it can have the opposite effect. Municipalities where there are few competing development localities have an incentive to restrict land supply in order to encourage increases in local land and property prices and, so, maximise their tax take. There have been complaints that some municipalities, especially in the areas of greatest shortage around the major cities, were adept at this activity in recent years and held back land supply. One consequence was the leapfrogging of development to more distant locations and resultant long commuting times.

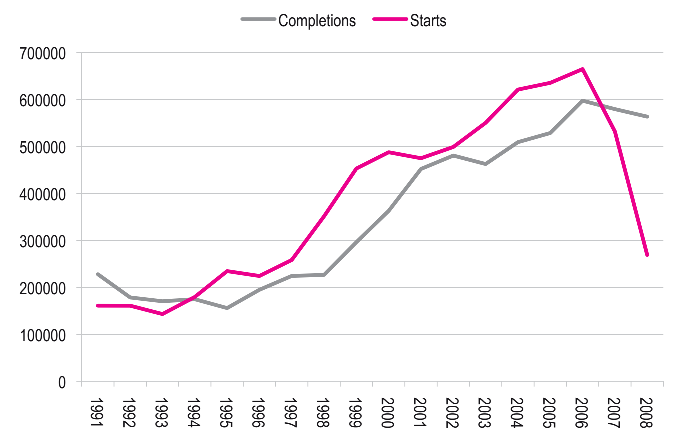

Figure 10.4: Housing starts and completions, 1991–2008

Source: Housing Ministry

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Macroeconomic influences

Although the economy is currently in a deep recession, there had been an economic transformation in Spain in the years prior to then. Up to 2007, economic growth was stronger than the EU average for well over a decade; with growth rates averaging 3-4%. Although population increases helped this expansion, GDP per capita now more than matches the EU average. Job creation was also strong and the labour participation rate has risen to almost 75%.

In 2008, the economy slowed significantly, with the decline in housebuilding being an important contributory factor. Growth just about remained positive; partly due to a fiscal stimulus that was equivalent to 1.5% of GDP. This did not stop the economy sharply contracting in 2009 and it is likely to bottom out only in 2010, after which growth will be limited for some time to come, as the economy becomes more competitive and slowly adjusts away from its previous high reliance on construction and property.

Spain's higher than EU average inflation rate in the years prior to the slump means that it has lost international competitiveness. Furthermore, exporters face the pressures of a high euro exchange rate outside of the euro zone. So, the future of the housing market rests on how far the general growth rate can be increased through productivity improvements to overcome threats to international competiveness and to increase efficiency in service activities. If the economy stagnates for some time, the prospects for the housing market are likely to be poor.

High unemployment is a characteristic of the economy. It was still 8% at the peak of the last boom in 2007 However, the economic slowdown is pushing unemployment up quickly and it is forecast to reach 19% in 2009/10 though that is less than the unemployment peak of 24% seen in 1994. Rising unemployment threatens to raise repossessions substantially as there are so many homeowners with mortgages. Hopefully, the emergency measures enabling the unemployed to defer part of their mortgage payments will limit the potential onslaught of high default rates.

Labour market restrictions, including job protection legislation, are said to contribute to the high unemployment rate. The price indexation of many wage contracts also means that inflationary pressures are rapidly transmitted through the labour market. The government deficit has risen to almost 10% of GDP, and when it begins to be reduced through fiscal policy that may represent another negative influence on the housing market.

Mortgage markets

The impact of the economic slowdown and the reduction of activity in the housing market has led to a sharp reduction in new mortgages issued, so that the growth in outstanding mortgages had fallen to about zero in autumn 2009 (Figure 10.5). The prospect is that there will now be a net repayment of mortgage debt after years of very high growth.

It has been widely noted that Spain's major financial institutions have so far not been as badly hit by the credit crunch as in other countries. The biggest bank, Santandar, has even acquired stricken banks in other countries, notably Alliance and Leicester and the deposit side of Bradford and Bingley in the UK. The smaller savings banks, the local and regional Cajas, are more exposed to real estate losses.

One reason for the sharp curtailment in mortgages is that Spanish financial institutions relied increasingly on securitised vehicles for finance during the housing boom. Lenders came to rely on capital markets for about 40% of loan funding through covered bonds, mortgage-backed securities and other vehicles. By q1 2008, they had the largest share of all European capital market mortgage funding: 24% of it, divided between €109bn of residential mortgage-backed securities (RMBS) and €267bn of covered bonds[9]. So, the closure of the international RMBS market has affected Spain badly and covered bond spreads widened considerably. ECB intervention through a euro zone cover bond purchase scheme early in 2009 restored confidence on narrowed spreads, while other ECB active market operations helped to keep up mortgage lending and lower lender spreads.

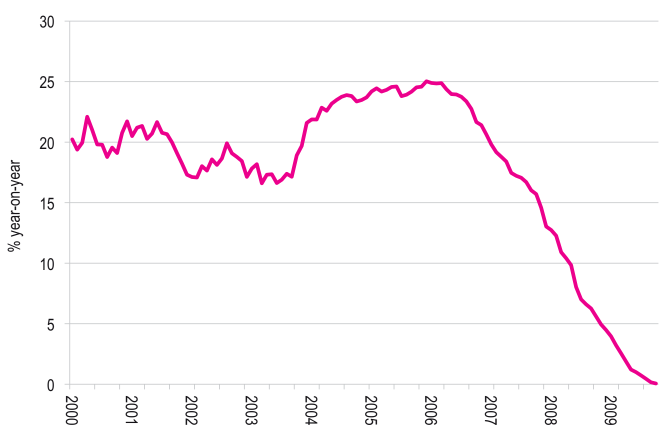

Figure 10.5: Rate of growth of outstanding housing loans, Jan 2000–Oct 2009

Source: Bank of Spain

[9]*Crosby, Mortgage finance interim analysis, HM Treasury, London, 2008.*

Mortgages are mainly advanced by banks. The standard mortgage product is a variable rate one, with EURIBOR typically used as the reference rate. Lending conditions have been tightened, with much of it occurring in 2008. According to the central bank, the average loan-to-value (LTV) ratio on new lending was 57% in q2 2009, down from 64%, and the proportion of new loans with LTVs above 80% has halved since 2006 to 10%. The 80% LTV ratio forms a financing threshold, because banks are required to increase their capital adequacy provisions when lending above it[10]. Maturities are also down to 24 years, whereas they had been growing during the boom years as a means of keeping annual annuity costs down.

Increases in mortgage interest rates had helped to puncture the housing boom as they almost doubled between 2005 and 2008, when they peaked at over 6% in the autumn. The falls through 2009 were marked and borrowing rates were down to 3% by October. This fall clearly helped to improve housing market conditions and explains why several indicators showed a levelling off after the period of sharp decline[11].

Default levels are currently low but are likely to continue to rise, especially as unemployment is growing so fast. In the last housing market downturn from 1991 to 1993, when the economy overall was also experiencing problems, banks faced high levels of mortgage default. Around 7% of the mortgage market consists of lending to foreign residents and it has a default rate twice that of households as a whole[12].

Mortgages traditionally played a small part in housing finance and have only become commonplace during the recent housing market boom. So, the current volume of outstanding mortgage debt started from a low base. Outstanding residential mortgage debt was only 14% of GDP in 1990[13]. Now total household debt, much of it mortgages, at around 125% of gross personal disposable incomes, is one of the highest in Europe.

In 2004, the Finance Minister announced that borrowers would be able to switch their loans from one lender to another without having to pay fees for doing so, in a move aimed at intensifying competition in the existing mortgage market. This put pressure on the previous dominance of savings banks as commercial banks were more able to compete for their existing customers. This type of competitive interplay is likely to have encouraged some participants to take on greater lending risks than they might otherwise have done.

[10]Bank of Spain Quarterly Report on the Economy, November 2006.
[11]Bank of Spain Quarterly Report on the Economy, November 2009.
[12]Bank of Spain Financial Stability Report, November 2007.
[13]Housing Statistics in the EU, 2004.

Demographic influences

The reduction in the birth rate and the ageing of the population are having significant effects. Demographic data show that a surge in household numbers took place from 1997 to 2001. This rise, it should be noted, corresponded with the early years of recent housing market upswing, so demography played a key part in its development. Forecasts suggest that demographic factors will put further pressure on local housing markets in the future, because of the age profile of the population and the reduction in household size, which is gradually converging on that in many other EU countries. Furthermore, the greater affluence of younger people means that they are increasingly reluctant to stay at home with their parents until so late in life as in the past.

There is also significant movement of people towards the bigger, more economically successful parts of the country. Some of the older industrial districts and rural parts of the country are now experiencing large vacancy rates in their housing stocks, while chronic shortages remain elsewhere.

The birth rate fell during the 1980s and 1990s to one of the lowest in Europe. However, recently it has revived to around the replacement rate but still is much lower than it traditionally had been. Fewer children born since 1980 will translate into less house purchasers 20 to 30 years later. So, domestically generated demographic pressures are currently diminishing.

Part of this change arises from the greater role of women in the labour market and in higher education, both of which encourage later childbirth. Other important factors are high and insecure employment, particularly amongst younger men who fall outside of the gains from labour market regulations. This has delayed the age of marriage for many, while already married and co-habiting couples have put off having children, partly because of the difficulty of finding larger, affordable accommodation within reasonable travel-to-work distances. Demographic factors will gradually alter the demand for particular house types as current age cohorts move through the stages of their housing life cycles.

The rate of immigration into Spain is by far the highest in Europe. Net migration into Spain was almost 40% of the total of that into the EU as a whole in 2007. As a result, the resident foreign population has increased from 920,000 in 2000 to around 4.1 million in 2007, and the percentage of foreigners has risen to 11% of the population. However, the numbers of immigrants shrunk significantly in 2008 and 2009 as a result of the economic crisis.

There are a variety of different types of immigrant. Some are predominantly older people from north west Europe, particularly the UK, who wish to settle in Spain but not to participate in the labour market. They are a mainstay of demand in the coastal and other tourist areas. Others come from central and eastern Europe, Africa and Latin America and migrate for economic reasons. Their typical current low incomes mean that they often have a difficult time finding housing in a country where owner occupation is so predominant.

The areas experiencing the greatest increase in household numbers are predominantly those with the fastest economic expansion. Increasing immigration from abroad is creating housing problems in such areas, because understandably they are the places where work-related migrants wish to live but face affordability problems on their low incomes.

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Factfile: Spain

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
45.6	1.5	1	81

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	102	104	106	104	-
Real GDP growth %	3.6	4.0	3.6	0.9	-3.6
Growth in real private consumption %	4.2	3.8	3.6	-0.6	-5.1
Inflation – consumer prices % (HICP)	3.4	3.6	2.8	4.1	-0.4
Labour participation rate % (15–65 yrs old in work)	-	-	73	74	75
Employment growth	-	-	3.1	-0.5	-6.8
Unemployment rate %	9.2	8.5	8.3	11.3	18.1

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	6.1	6.2	3.0	-10.3	-25.5

Housing market

- Owner occupied housing: Mortgage interest relief – yes, with caps & exceptions.
- Capital gains exempt – yes
- Imputed rental income – not taxed

- Stamp duty: 0.5–1.5%
- VAT on new dwellings: 7%
- Property taxes as share of all taxes 2002: 7%
- Property taxes as share of GDP 2002: 2%

Taxes

Sources: Housing Statistics in the European Union 2005/6, Eurostat, OECD.

CHAPTER 11: SWEDEN

Overview

Like other European countries, the Swedish housing market was affected by the world economic crisis. But the fall off in prices was modest. It only started in q4 2008, with a 4% price decline for single-family houses over the winter months. But, property prices were rising again by the spring, according to Statistics Sweden, and continued to climb throughout 2009, with third quarter prices 7% higher than first quarter 2009 ones and back to their pre-crisis levels.

Other house price indices, such as that of Maklarstatistik, indicate even higher rates of house price increase during 2009 than the official data, perhaps because they are derived from an earlier stage of the house sales process. That source suggests that the price of flats rose by 10% in the year up to October 2009, and that houses were up by 4%.

So, it would seem that Sweden currently has one of the most buoyant housing markets in Europe, at least in price terms. Its buoyancy has been aided by very low interest rates that seem to have been fully passed onto mortgage borrowers, unlike experiences in many other European countries. Average variable mortgage interest rates were below 2% late in 2009.

Sweden experienced one of the largest increases in house prices in Europe in the last boom. That boom lasted from 1997 to 2007 with annual house price rises averaging 8% (Figure 11.1). A nasty shock did occur in the aftermath of the dot.com crash, which particularly affected the IT-oriented Stockholm region and its housing market. (The Stockholm market generally tends to be more volatile than elsewhere in the country.)

Although the average national rate of increase of 8% may not seem that large in relation to the booms in some other countries, those increases went on for a long time - a dozen years in fact. The result was that overall real house prices rose by 2.3 times over the period from 1995; which was a larger increase than in many other countries, including the booms experienced by Australia, Finland, Spain and the USA. One type of property that experienced sharp price rises, particularly in the years towards the end of that boom, was owner flats (which have a specific legal status in Sweden and are called 'tenant-owned', as described later). During 2006 and 2007, their prices were rising at a rate of 20% or more annually in the major cities and they were once again leading price rises in 2009[1].

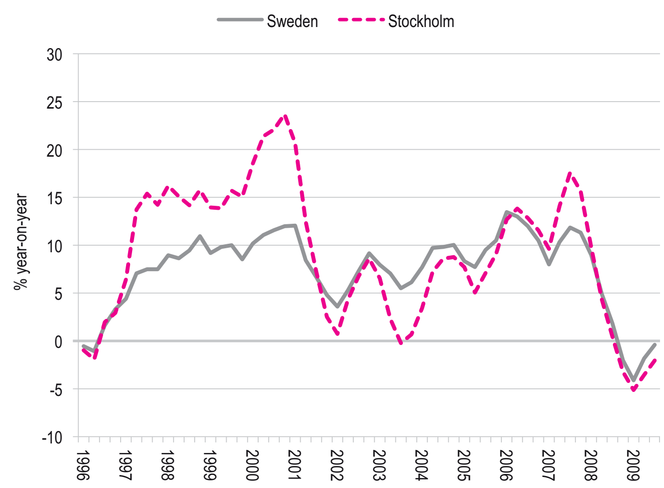

Figure 11.1: House price growth, 1996–2009

Source: Statistics Sweden

[1] *This may to an extent be a statistical artefact because it is difficult to collect good data on prices in this segment of the market and quality adjustment of prices is also problematic. However, other data on transactions and building also suggest that this is a buoyant sub-market.*

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House price growth has been strongest in the major cities – Stockholm, Gothenburg and Malmö (Figure 11.2) – and in university towns, like Uppsala. These areas are the ones experiencing the greatest economic expansion and inward-migration from slower growing regions and abroad. In housing terms, Sweden consists of two halves: the growing cities and their surrounding regions, where demand consistently outpaces supply, and the rest of the country where the reverse situation generally pertains, of weak overall demand and an excess supply of poorer-quality accommodation. The Stockholm region alone generates around 40% of total Swedish GDP and is experiencing rapid population growth, while many other parts of the country are experiencing economic stagnation and declining populations.

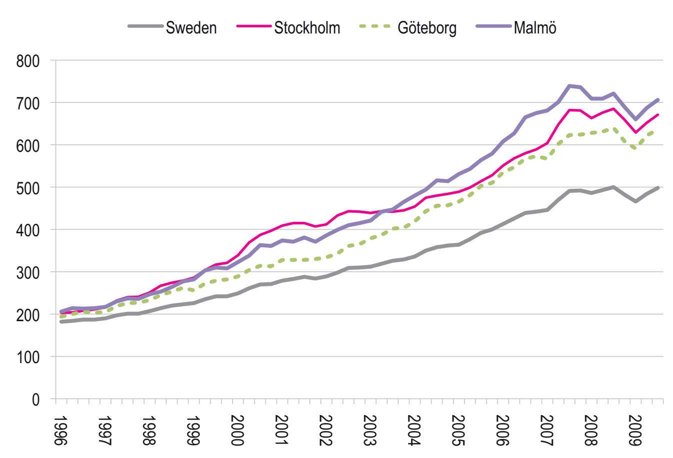

Figure 11.2: House prices in the major cities, 1996–2009 (1981=100)

Source: Statistics Sweden

Because of tight supply, the major city housing markets tend to be more volatile over market cycles. True to form, they experienced the sharpest corrections in the late 2008 slowdown but also the most rapid recovery in prices in 2009. Certain unique factors help to differentiate performance across individual city markets. For example, the Malmö market is now influenced by events in nearby Copenhagen, because of their close proximity since the opening of rapid transit links between them.

In contrast to prices, other indicators of housing market activity highlight that the Swedish housing market remains at a markedly lower scale of activity than prior to the recession. Sales of houses fell sharply in the crisis period, especially in the second half of 2008 and into 2009 (Figure 11.3). Even though they did increase again from spring 2009, by October they still trailed 14% behind their equivalent 2007 levels.

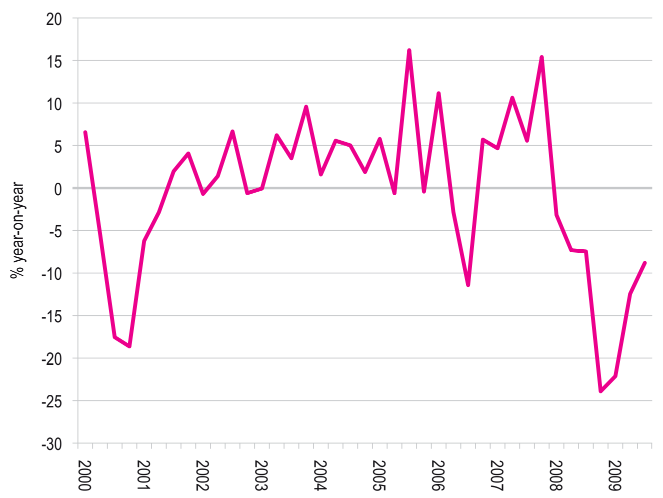

Figure 11.3: Growth in house sales, 2000–2009

Source: Statistics Sweden

A stimulus programme to protect employment late in 2008 pumped billions of kronor into the construction sector during 2009 and will continue to do so in 2010. Even so, housebuilding continued to decline in 2009, following previous sharp falls in 2008. The number of dwellings started in the year to November 2009 was 30% lower overall; with much a greater decline in the single-family home sector (down 41%) than for flats.

By contrast, mortgage growth continued to be strong; up by 8% in value on the year to September 2009. A cause of the growth in mortgage demand was that existing homeowners and those wishing to renovate newly purchased properties could take advantage in 2009 of the lower tax breaks on building, renovations and maintenance introduced as part of the aforementioned stimulus package.

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A combination of relatively good market liquidity, attractive borrowing costs, temporary tax breaks and renewed expectations of house price growth has helped to rekindle interest in purchasing. At the same time, supply is severely limited by a shortage of new stock and a reluctance of existing owners to sell. That reluctance is self-reinforcing because restricted opportunities to buy discourage existing homeowners from putting their own dwellings on the market. So, with rising demand chasing inadequate supply, the pressure is on prices. Rising prices amidst unusually tight supply could continue for some time. Yet, the longer it lasts the greater is the chance that the authorities would tighten up monetary conditions significantly to head off a housing asset price boom. That, in turn, could reinforce the likelihood of a housing market 'recovery' in which there is a relatively low level of market activity and many frustrated households who want to move. Deep-seated housing supply problems in the growing city regions, which played such an important role in the long house price boom up to 2008, will help to make future housing market recovery difficult and volatile.

Years of sustained borrowing now mean that Swedish households are some of the most highly indebted in Europe, with a debt to disposable income ratio of around 155%. According to the central bank, that ratio has risen by a third since 2000, mainly due to extra mortgage debt, and it is expected to rise even further in the course of the next year or two.

During the recent boom, a story familiar in several other European countries was played out. There were four core influences on the scale of the price upswing, which can be summarised in 4 R's: Rising incomes in a buoyant economy; Rigid housing markets with poor supply responses; Rapid migration into and natural population growth in the booming regions; and, finally, Relaxed credit conditions, with a greater range of mortgage products on offer, easier terms and lower interest charges. Additional factors were associated with positive demographics and changes in the tax environment, which for movers was tipped further in favour of ownership away from renting. Nonetheless, many other characteristics of the housing system offer considerable benefits to those existing tenants content to live in their present accommodation, as will be discussed below.

With only a moderate, short-lived downturn and then renewed pressure on prices within a matter of months, the current housing market experience is vastly different from that in early 1990s. At that time, the housing market underwent a massive decline and real house prices fell by 30% from their previous peak. The spillover effects of that crash forced the government to rescue the Swedish financial system. So, the country has already had experience of events that have been affecting many other countries recently. Perhaps, the authorities learnt the appropriate lessons from the early 1990s debacle which have now helped them steer recent events, although it is still too early to be sure that the housing market is fully out of trouble. A worry is that if interest rates do rise sharply - as is expected over the course of 2010-11 - and unemployment continues to rise, there is a risk that a large number of households may experience payments difficulties, which then would cause house prices to fall[2].

If full recovery happens without a further price drop, it may be due to good fortune as much as skill, because severe distortions continue to persist. The relatively small owner occupation sector by international standards has a deeply troubled supply-side; it contains only an indirect and unique way of buying flats in the so-called tenant-owner framework; and it exists in a highly-regulated and heavily sitting tenant biased overall housing system.

The central bank explicitly examines house prices as part of its interest rate setting strategies; a policy re-emphasised by the deputy governor in a speech in December 2009. As house price rises are now quite strong and increases are being encouraged by very attractive borrowing rates, this may persuade the central bank to raise the repo rate more quickly than might otherwise have occurred in an attempt to moderate housing demand. The economy as a whole may therefore pay a price in 2010 for the recent resurgence of the housing market.

Housing system

The country has long been famous for its interventionist housing policies, with a strong emphasis on social housing and market regulation. The current housing situation partly derives from huge levels of public investment in multi-family dwelling buildings, many derived from a 'million homes' programme in the 1960s and 1970s.

Between the 1950s and the 1990s, substantial subsidies and tax breaks were given to all tenures to raise the number of new dwellings built and to enable all households to exercise tenure choice. Then, during the 1990s, subsidies were slashed and housing policy was given far less government attention and even the housing ministry was symbolically abolished for a while, with responsibility for housing now residing in the environment ministry. With the reduction in subsidies, housebuilding collapsed from around 65,000 units annually in the early 1990s to reach a low point of 11,000 units in the late 1990s[3].

[2] *Risks in the Financial System, Finansinspektionen, Stockholm.*
[3] *Housing Yearbook.*

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Despite the apparent withdrawal of the state, the housing market is surrounded and structured by a series of state-led constraints, incentives and policy initiatives. So, Sweden still has one of the most overtly and complexly state-managed housing systems in the world. Whether this has led to a better overall housing situation compared to less-regulated countries with similar standards of living is a matter of debate. The issues centre on the cost, distributional and efficiency consequences, and the degree of flexibility to cope with shocks and surges and declines in demand.

The distribution of housing opportunities favouring incumbent households over newly- or recently-formed ones and others wishing to move: particularly into and within places where economic growth is strong. In other words, it is a system where lucky ‘insiders’ gain at the considerable expense of ‘outsiders’. This not only creates unintended social consequences but also imposes significant economic costs. Added to the cocktail is a political scene with recent closely fought elections, which have encouraged government to cut property taxes and to put housing market reforms on the back burner.

Owner occupation has become the sole option for housing aspirations of many in a situation of constrained supply. This has led to higher prices, which have generated wealth gains for some – either in the form of direct housing wealth or the implicit value of the right-to-live in a rental home at substantially below market value – and, so, has led to inequalities that the original interventions were supposed to smooth out. Moreover, it means that variations in housing demand are predominantly borne in the relatively small owner occupied sector, which makes it prone to greater volatility than would otherwise be the case.

The housing system is quite complex. There are four tenures: single-family owner occupied, tenant-owner co-operatives, and private and public rental. 39% of all dwellings are single-family owner occupied, 19% are in the tenant-owned co-operative sector (which are owner occupied on a specific basis, see below) and 42% are rented – almost half of which are in the private sector[4]. Therefore, slightly less than 60% of the housing stock is now owner occupied, well below the EU average of 70%.

Statistics on tenure shares have to rely on limited surveys but it does seem as though owner occupation is growing[5]. The proportion of single-family homeownership has expanded by around 5% of the housing stock since the early 1980s. The biggest stimulus to the homeownership rate is through tenant-ownership: both in terms of new build and the scale of conversion of private rental properties to tenant-ownership, so that there is now little private renting in inner Stockholm. Annual sales of tenant-owned properties now considerably outpace those of single-family houses - 88,000 compared with 57,000 family houses in 2008, for example, according to Statistics Sweden.

Tenant-owner may seem like a contradiction in terms to many but makes sense under the Swedish system of property law, under which parts of built structures cannot be subject to multiple ownerships. So, legally, tenant-owned co-operative associations ‘own’ the buildings in which apartments exist but their owner member households can sell their memberships of the co-operatives and the associated ‘right to occupy’ a given apartment on the open market.

Co-operatives typically own only one estate or apartment building. This means that a new one is generally formed for every project, be it new build or the physical and ownership conversion and modernisation of an existing rental property. In either case, the new association takes out a mortgage for most of the cost, with the remainder financed through contributions from co-operative members in exchange for a tradable right to occupy a specific dwelling. These contributions may be self-financed or funded by personal mortgages, provided under similar conditions to mortgages on single family houses.

Housing co-operative members are charged monthly fees to cover the costs of the mortgage taken by the association and maintenance and repair costs. The right of occupancy asset traded in the market for co-operative dwellings includes an obligation to pay the monthly fees associated with the dwelling. Traded prices consequently depend not only on the market value of the dwelling but also on the outstanding debt of the co-operative, on how well it is managed, the management and other charges imposed on co-operative members and the default risk of other co-operative members. Many of these items, of course, are not transparent. But as this tenure form is relatively recent in popularity its robustness through a period of housing market downturn has not really been tested until today.

The building and purchase of tenant-owned co-operative dwellings has been substantial and continues to grow. They are playing an important part in slowly increasing the role of owner occupation in Stockholm and other major cities, where renting predominates and the cost of single family housing is particularly high by Swedish standards. New co-operatives arise through the takeover of previously rented property as well as through new build.

Most conversions are from previously privately rented properties rather than public ones. The inability of public housing bodies to make profits or to transfer sales receipts to municipalities’ accounts means that there is limited incentive for large-scale social housing sales. Central government has also put caps on transfer numbers in locations where they are likely to affect the subsequent determination of average rents in areas of high demand (see later).

[4]Regular National Report on Housing Development in Sweden 2005.
[5]Partly, this is because there has been no available Census data since 1990.

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Taxes and subsidies

Overall, the tax system encourages house purchase over other investment options[6]. In general for owner occupiers, 30% of mortgage interest can be deducted at the purchaser's marginal rate of tax. Offsetting this, until recently, was a 1% real estate tax on the capital value of the property. In addition, there is a capital gains tax of 30% on two-thirds of any price rises. This can be deferred as long as another owner occupied property is bought, and the rule applies to heirs as well. These deferral provisions discourage owners from ever switching to renting. Finally, there is a wealth tax of 1.5% for wealth above SEK1.5 million (SEK3 million for couples).

Tenant-owner apartments have a somewhat distinctive tax regime, though it roughly approximates in average incidence to that for owner occupation. Individual members can claim tax allowances corresponding to 30% of the interest payments on the mortgages they take out personally. Some allowances are also given for the mortgages held by the co-operatives. Co-operatives' imputed rental income is taxed on the basis of the assessed value of the property, though in practice the tax rate is far from uniform because the relationship between assessed value and market value varies greatly.

A national real estate tax was abolished with effect from the beginning of 2008. It has been replaced with a municipal property fee amounting to SEK6,000 for a small house and SEK1,220 with caps on the share of assessed property values. This tax reduction has partly been offset by increasing capital gains taxation at the time of sale from 20% to 22%. But, overall, recent tax changes may have helped to sustain the buoyancy of house prices.

Housing cost assistance of up to a third of outgoings is provided for lower income households, other families with children, and pensioners. Around a fifth of all households are in receipt of them, mainly in the rental sectors[7]. Such means-tested allowances generate significant implicit tax rates on such households when their incomes rise and the allowances are withdrawn. They also do not encourage their recipients to economise on their housing costs.

Rental housing

Social housing is predominantly owned by municipal housing companies (MHC), which are independent, non-profit housing organisations owned by local authorities. Anybody can apply to live in a social rented dwelling, because traditionally the means-tested criteria that are common elsewhere in the EU do not apply.

The legally determined system of rent setting in both the private and social sectors requires that there are local negotiations between tenant organisations and MHCs for social housing and with private landlord organisations for the private sector. As rents have to be comparable across both sectors, and private tenants can appeal to a rent tribunal if they are not, the overall costs of local MHCs essentially set the average rent level. Rents are largely historic-cost based, dependent on outstanding debts, management and maintenance costs, and they consequently reflect the age composition of the social housing stock rather than prevailing market rent levels. One unfortunate side-effect is to limit the incentives MHCs have to be efficient, because they always know that rents will be set to cover their costs. Negotiations then determine rents for the different dwelling types and locations.

There has been some change in recent years, because any subsidy element (as defined through a court ruling rather than in economic terms) in public housing cannot be used in the comparison between public and private sector rents. However, as many MHC-owned dwellings are no longer in receipt of subsidies, the impact of the change is fairly limited in many localities.

Obviously, prevailing rental values are reflected in the capital values of residential investments, so that the returns on existing residential properties are sufficient to attract investors. The 3,000 plus properties covered in the IPD Sweden residential index had negative average returns in 2008 of -5% because a positive income return was counteracted by an 8% fall in capital values. However, previous years had seen positive returns because of rising property values and the revival in the housing market in 2009 may well see returns being positive once more.

The regulated rent setting process means that rents in attractive urban locations are often well below market clearing levels. As housing shortages have grown in the major cities, this has encouraged intricate rationing procedures to deal with excess demand and black-market transactions. Such procedures greatly raise search and other costs for prospective renters. Existing tenants can enjoy substantial windfalls by sub-letting or by requiring undercover ('key' or 'furniture' money) payments from new tenants before agreeing to vacate the property.

The cost-based rents of the social sector are low because the stock was mainly built before the mid-1970s and most of the debt on it is now paid off. Such rent levels do not encourage efficient use of the stock. Existing tenants have limited incentive to economise on housing consumption or to move to cheaper locations. Because the criteria for entry to the tenure has been very broad in the past, people from a wide variety of social strata and income levels can end up with substantial implicit gains, whose social cost is questionable. Queues to enter social housing are long in areas of high demand. The general allocation process has detrimental effects on labour mobility.

[6]*The Swedish housing market – better allocation via less regulation OECD Economics Department Working Paper no 559, 2007.*
[7]*Housing and Housing Policy in the Nordic Countries, M. Lujanen (ed.) Nord, Copenhagen, 2004.*

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There has been a gradual tendency for rents in nominal terms to rise, because costs are increasing as a result of the removal of subsidies. However, there are variations across regions, with Stockholm having the greatest divergence of actual from potential market rents and the rents on social housing in some of the depressed regions of the country probably being higher than open market levels. As rents have not risen to reflect prevailing market shortages in an era when house prices are rising, investment in new rental housing is, outside of the luxury sector, generally unprofitable and so does not occur.

There has been no equivalent of the buy-to-let booms and the resultant expansion of rental housing in the equally strong housing markets of Ireland and the UK, prior to 2007/8. Instead, the low profitability of new rental construction has constrained overall housebuilding rates, which is particularly important in a country where rented housing represents such a large share of housing at 42% of the stock.

Sweden has the smallest average household size in the EU at 2.1 persons per dwelling. This is partly due to the very high number of single person households, which at 41% is the highest in the EU, compared, for example, to 29% in the UK. Even so, the average number of rooms per dwelling is good at 4.3 and the overall quality of the housing stock is high – reflecting the years of high housing investment up to the 1990s[8].

Single-family owner occupied dwellings are exclusively found in one- or two-family houses, which represent 45% of the housing stock; while most rented and co-operative dwellings are apartments.

Housebuilding

Housing completions were rising quite significantly in the last years of the boom but were still some of the lowest in the European Union in relation to population size. Sweden's low housebuilding rate is on a par with the Netherlands and the UK and so is one of the true European laggards.

The collapse in housebuilding in the early 1990s was spectacular and rental housebuilding since then has only partly revived (Figure 11.4). Within the owner sector, in the last years of the boom a surge in apartment building in tenant-owner co-operatives boosted output (Figure 11.5).

The improvement in housing supply seems to have continued into 2008, although at a slowing rate. Starts have been falling every year since 2007 and in the first nine months of 2009 were 31% down on the previous year, with the greatest fall in single-family housing[9]. The collapse in multi-storey building was particularly marked in Stockholm, signalling the end of the boom there in the tenant-cooperative sector. However, it should be noted that subsequent revisions to these data may reduce considerably the apparent decline, because often there are substantial upward revisions to the published information. The revival in house prices during 2009 does not seem to have filtered through to new build yet, though it may have more of a positive effect in 2010.

Housing construction costs are the highest in Europe, according to Eurostat, at around 55% above the EU average. The OECD attributes high house building costs to market structures that evolved in the era of high housing subsidies, limited competition, low levels of construction imports, and heavy regulations – all of which constrain competition and innovation[10].

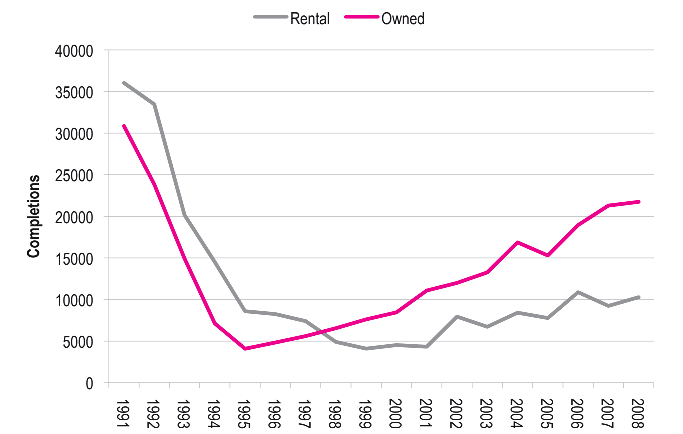

Figure 11.4: New housebuilding by tenure, 1991–2008

Note: Owned includes single family houses and tenant-owned apartments
Source: Statistics Sweden

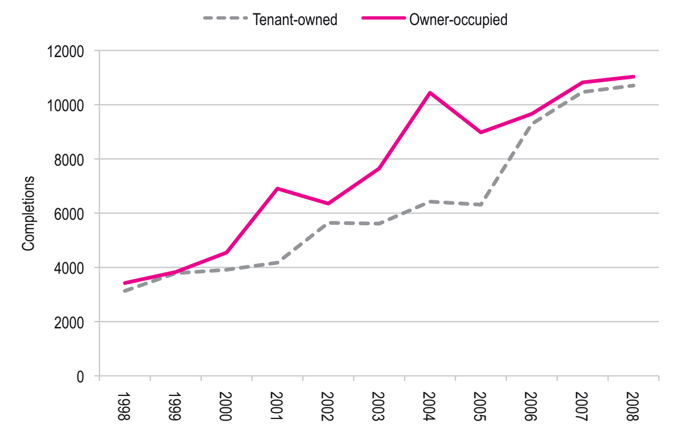

Figure 11.5: New owned dwellings, 1998–2008

Source: Statistics Sweden

[8] *Housing Statistics in the EU, 2004.*
[9] *Statistics Sweden.*
[10] *The Swedish housing market – better allocation via less regulation OECD Economics Department Working Paper no 559, 2007.*

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Supply responsiveness is also affected by land supply constraints. Land shortages occur for NIMBY reasons. Complex and lengthy processes of plan formulation and then appeals procedures generate considerable delay even where residential development is permitted. Furthermore, the structure of local authority finance discourages new development. Until the 2008 reforms, no local taxation was derived from property and it remains to be seen what will be the long-run effect of the new property tax on local authority willingness to facilitate new development. But municipalities still have large upfront costs, with little prospect of payback for many years to come, so the incentives still do not seem particularly positive.

Supply-side delays can spring up for ostensibly unexpected reasons. For example, the owner co-operative form of housebuilding may be the fastest growing tenure, but the process of setting up a co-operative is slow and cumbersome. So, the tenure is a tardy means of getting new housing on stream.

Macroeconomic influences

The economy has been at its weakest for 30 years as growth ground to a halt in spring 2008 because of the impact of the global economic crisis. The recession deepened in 2009 with a 5% fall in GDP, although recovery is forecast for 2010. Previously, the economy had been expanding at a high rate for a long period, surviving a minor blip in 2001 and 2002. This strong economic performance underpinned housing demand during the boom years.

The slowdown in the economy has been squeezing out inflation, which had been rising in the years prior to 2008. Rising unemployment towards 10% is an indicator of continued excess capacity, which may be around for several years to come. Until 2008, job creation had been high in the booming regions and unemployment fell rapidly, and those regions are likely to recover fastest now. The country has one of the highest shares of employed people in the working age population at 79%. Participation rates are particularly high for women and older age groups.

The state is an important conduit within the economy and general government expenditure represents a high share of GDP. Associated with such state involvement are high taxes, a variety of tax deductions and a sensitivity of consumption and investment patterns to them. The centre-right government is midway through a major privatisation programme but has put it on hold until stock market conditions improve.

The government announced a SEK23bn spending package in December 2008 in an attempt to counteract the recession. It focused on employment and training but included an increase in the tax deduction available for home repairs and maintenance, including energy efficiency measures ("ROT-avdrag").

The central bank has also been active in trying to stimulate the economy through interest rate and other policies. In August 2009 it became the first central bank to introduce negative interest rates on bank deposits in an attempt to encourage more bank lending.

Mortgage market influences

In recent years, the covered bond market has come to be a large source of funding for mortgage lending. The first were only issued in 2006 but they now amount to SEK120bn, representing 13% of banks' sources of finance in September 2009[11]. New issuance has continued to grow, reaching almost SEK45bn in 2008, and most outstanding mortgage bonds have been converted to covered bonds. Covered bonds are more creditworthy than residential-mortgage backed securities for a variety of reasons, including special rights in bankruptcy.

The collapse of Lehman Brothers in autumn 2008 badly affected Swedish capital markets, as elsewhere. Difficulties were concentrated in mortgage-backed securities and the spread between 5 year mortgage and government bonds rose from 60 basis points in January 2008 to touch 200 basis points in September in the aftermath of the collapse of Lehman Brothers. It then fell sharply from March 2009 and was around 75 basis points later in the year, still significantly above its pre-credit crunch level. However, international investors have still not returned to the Swedish market, according to the central bank's November *2009 Financial Stability Report*.

The government has taken strong action to protect the financial system. As well as stepping up the provision of liquidity, the stability plan of 20 October 2008 included a guarantee programme of up to a maximum of SEK1,500bn to support the medium-term financing of the banks and mortgage institutions and to set up a long-term stability fund to deal with any future solvency problems which, along with the deposit guarantee fund, will average 2.5% of GDP within 15 years[12].

Lending grew strongly during the course of the long housing market upswing, aided by loosening credit conditions and competition between mortgage providers. The sharpest increases were associated with tenant-owned properties; where borrowing is now over nine times the size it was in 1998[13].

Recourse to flexible interest mortgages and the five year renegotiation clause in fixed interest contracts have meant that there has been limited mortgage churning caused by households refinancing their debt. There also does not seem to have been a large amount of equity withdrawal as there has been in some other European countries.

[11]Swedish Central Bank; European Covered Bond Council.
[12]Swedish Central Bank Financial Stability Report 2/2008.
[13]Swedish Central Bank.

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Despite the problems generated by the credit crunch, mortgage lending has remained strong. Lending to households for housing purposes was set to grow by around 8% in 2009[14]. So, a mortgage famine as experienced in some countries like the UK has not occurred in Sweden. Nonetheless, lending institutions have become more cautious and have tightened up their lending criteria, including the limiting of maximum LTVs and the withdrawal of interest-only loans for new borrowers.

Many homeowners take out a mixed package of mortgage and other housing finance products with different term-structures when negotiating their home finance. In the years up to the onset of the credit crunch, loans were normally granted up to 90% to 95% of property value, although on a case by case basis banks were prepared to offer 100%+ loans. Interest-only loans also became more common, prior to the crunch. Lending terms have been curtailed over the past 18 months but still remain relatively relaxed compared to some other countries[15]. However, the central bank remains unconcerned about the ability of most households to finance their debts and also thinks that the risks of mortgage debt to the financial system remain slight.

Average mortgage interest rates fell from just under 6% in 2002 to less than 3% at the end of 2005. This unsurprisingly helped to fuel the demand for mortgage credit and to push up house prices. From 2005 to 2008, mortgage interest rates then steadily rose again and by the end of 2008 had reached virtually the same level as they were in 2002. The cut in the central bank's repo rate in coordination with other central banks in the autumn of 2008 was not initially reflected in mortgage interest rates. But from the end of 2008, they fell substantially, especially for variable rate products, where rates fell to only around 1.5% (Figure 11.6).

Traditionally, single-family owner occupied housing was generally financed through long-term mortgages, with interest rates fixed on a five year or longer term basis. More recently, shorter term and variable interest rates have become the most important, accounting for 70% of new loans in q1 2009. Their uptake obviously varies with expectations about the future of interest rates but when interest rates fall, as they have done recently, variable rate products rapidly gained market share. Even the fixed interest rate market is now dominated by terms of less than five years[16].

Mortgages are provided in the main by Housing Credit Institutions (HCIs), a type of mortgage bank which is often part of broader financial conglomerate, and also by commercial banks. HCIs finance themselves by issuing bonds and other instruments on the capital markets. These are predominantly purchased by the domestic institutions that manage financial assets, such as insurance companies, pension funds and banks, though about a quarter of the bonds issued in 2006 were denominated in foreign currencies indicating foreign interest prior to the world financial crisis as well.

There is some guaranteeing of mortgage loans by an apparently self-financing system run by a state institution, the National Housing Credit Guarantee Board. There is also a state-owned mortgage lender, SBAB, the mandate of which is to ensure diversity and competition in the residential mortgage market, whilst operating on commercial principles. It currently has a market share of around 7%.

Five mortgage institutions are owned by commercial banks in a similar way to the situation in other Nordic countries and Germany, but two are state owned (SBAB and Venantius AB) with a joint market share of 14%. The two largest HCIs, Stadshypotek and Swedbank Hypotek, have about 59% of total HCI business[17]. There are five major HCIs, which compete fiercely with each other.

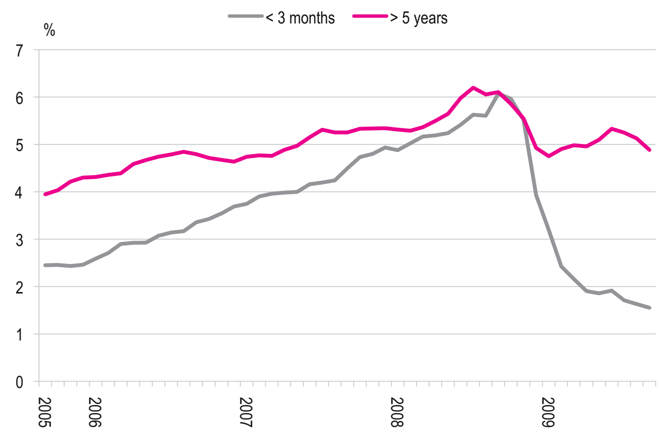

Figure 11.6: Housing Credit Institutions' lending rates on new business, Sep 2005–Sep 2009

[14] *Statistics Sweden.*
[15] *Financial Stability Reviews December 2007 & 2009, Swedish Central Bank.*
[16] *Swedish Central Bank & Statistics Sweden.*
[17] *The financial market in 2007, Swedish Central Bank.*

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Demographic influences

Household formation is low and the birth rate is 1.8 per woman of childbearing age. Immigration is also relatively low. The result is that the current population of around 9 million is only expected to grow by around 1% by 2010 and to increase slowly by around 6% by 2020.

The share of the population over 65 is only expected to grow by 5% by 2050, so that ageing problems are less than elsewhere in Europe. As so many households already consist of one or two people, household numbers are not expected to rise much either.

The biggest demographic impact on the housing market is migration from economically declining areas to the booming ones. Most population growth is scattered across the south of the country with declines in the north and, even within the south, population is moving towards a limited number of regional centres and the Greater Stockholm area. Research has shown that there is a clear positive correlation between the rate of inward migration to a local area and the rate of change in house prices. The level of vacant socially rented dwellings is also far lower in the growth areas and local incomes are higher.

CHAPTER 11: SWEDEN

Factfile: Sweden

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
9.2	0.8	2	79

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	120	121	122	121	
Real GDP growth %	3.3	4.5	2.7	-0.4	-5.5
Growth in real private consumption %	2.7	2.5	3.1	-0.4	-1.2
Inflation – consumer prices % (HICP)	0.5	1.4	2.2	3.4	0.3
Labour participation rate % (15–65 yrs old in work)	-	-	81	81	-
Employment growth	-	-	2.5	1.2	-2.3
Unemployment rate %	7.7	7.1	6.1	6.2	8.2

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	15.9	14.7	8.7	-5.4	-22.3

Housing market

- Owner occupied housing:
- Mortgage interest relief – yes, with caps & exceptions.
- Capital gains exempt – no but reductions
- Imputed rental income – not taxed for single family homes.

- Stamp duty: 0.5–1.5%
- VAT on new dwellings: 25% (though with variations)
- Property taxes as share of all taxes 2002: 7%
- Property taxes as share of GDP 2002: 2%

Taxes

Sources: Swedish Central Bank, Eurostat, OECD.

CHAPTER 12: UNITED KINGDOM

Overview

Prices in the UK market started to fall in spring 2008 and by a year later had dropped by over a fifth, according to the Halifax house price index, or by a quarter in real terms. Yet, for the rest of 2009 they started to rise again and by the end of the year they had risen by 8.5% from the trough. The revival of prices was greatest in London and the south east. It was encouraged by buyers - drawn to purchase by lower prices, attractive borrowing rates and somewhat looser mortgage constraints - chasing a limited supply of good quality properties for sale.

The ratio of house sales to the stock of unsold properties on surveyors' books increased for the eleventh consecutive month in November 2009, according to the RICS monthly survey. This activity was reflected in completed transactions, up by over 10%, and mortgage approvals were almost 80% higher in October 2009 than they had been a year before.

Overall, however, the market remained very subdued compared to the final years of the boom. The UK experienced one of the most dramatic collapses in housing market activity with the onset of the credit crunch. The recovery figures for the last nine months of 2009 indicate as much the scale of the market collapse, which occurred between autumn 2007 and spring 2009, than any true recovery in market activity. For example, mortgage approvals were still 56% below the 2006 peak levels. This was partly because remortgaging has not recovered at all but also reflects the low level of market activity. However, it seems clear that the market has bottomed out.

Indicators of mortgage distress did not climb as high as some had forecast and were improving in 2009. The Council of Mortgage Lenders twice revised downwards its initial prediction of the number of repossessions in 2009 from the initial one made late in 2008 of 75,000 in 2009, and by November 2009 was predicting a more moderate rise to 48,000. Things have not been as bad as expected, partly due to low interest rates, though they are by no means good.

The UK economy stayed in recession longer than any other major economy but some degree of growth is expected in 2010. With housing supply continuing to be tight and interest rates likely to remain low, it seems unlikely that prices will dip again but activity should still be constrained. The economy remains weak but interest rates are likely to rise at some time in 2010 from their current low levels. Mortgage lending will also remain constrained.

As a result, the expectation is for a continuing slow housing market recovery with muted price increases, particularly outside of London and the south east. If credit constraints do loosen, a tight supply situation may lead to greater upward pressure on prices.

The new homes market was severely affected by the downturn. Private housing starts in England in q4 2008 were a substantial 71% down on their peak approximately two years earlier in q1 2006[1]. They then recovered again by 66% in the first nine months of 2009, as builders responded to improved market conditions, but that still left them at less than half the level of the boom years. The decline in completions was smoother but private housing was still down by a half by the end of 2009, although public intervention to support the construction industry through additional social housebuilding slightly offset the fall (Figure 12.2).

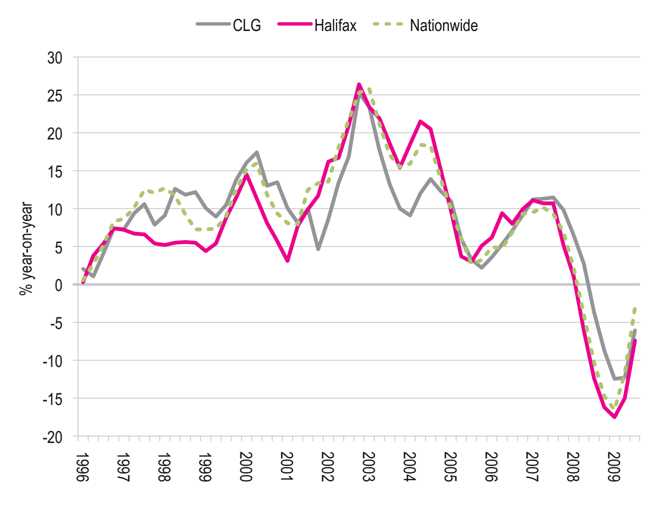

Figure 12.1: House price inflation, 1996–2009

Source: CLG, Lloyds-Halifax, Nationwide

[1]*CLG.*

CHAPTER 12: UNITED KINGDOM

The housing system

Most Britons are homeowners with 68% of households in the tenure. In many parts of the country, the share is even higher but in the big cities, especially London, it is much lower. Nationally, 18% of dwellings are socially rented and 14% are rented privately[2].

Homeowners had been rapidly growing in number over a long period. By 2006, there were 18.5 million owner occupied dwellings in the UK, 50% more than 25 years before. However, the homeownership rate has fallen marginally in recent years, because the number of owners stopped growing in 2003 while overall households numbers have continued to expand (by almost 1 million in the 2000s); with most of the increase absorbed in the private rented sector.

Affordability constraints during the house price boom were initial causes of the end of the expansion of homeownership. Since the onset of the financial crisis, credit constraints have tended to affect potential first-time buyers especially badly. If, as expected, credit constraints remain tight even after the recovery and lenders raise their spreads on mortgage lending, the homeownership rate may begin to fall more sharply.

Homeowners tend to be settled. Over 80% have lived where they are for at least 3 years and a third have not moved for over 20 years. In particular, those over 50 tend to stay put. 45% of owners have no mortgage. Because a growing number of older people are now outright homeowners and an increasing number of younger people are finding it difficult to enter homeownership, the already large wealth disparities between the young and old are increasing.

There is no tax relief on mortgage interest for owner occupiers since gradual abolition of the tax-break during the 1990s but capital gains are tax-free as is imputed rental income. There is a stamp duty tax on transactions above £125,000. It rises in steps up to 4% for properties worth more than £500,000. After each threshold, the whole of the purchase price incurs the new higher rate, so the tax creates pricing and transaction anomalies around the thresholds. There is no VAT on new housing, unlike the situation elsewhere in Europe, but expenditure on home improvements and extensions are subject to VAT at the normal rate of 17.5%.

To stimulate demand there is stamp duty exemption in certain disadvantaged areas. Moreover, as part of housing stimulus measures, the 1% stamp duty levy was waived on properties worth between £125,000 and £175,000 from September 2008 to December 2009.

As a result, in the year to September 2009, over a 130,000 dwelling purchasers benefited, 27% of transactions in the period[3]. It is unclear how many of these sales were induced by the temporary exemption, which had a small effect on purchase costs in relation to contemporary changes in house prices and interest rates. However, surveyors outside of the more expensive south east were concerned that housing demand might be lowered in 2010 as a result of the re-introduction of the charge. VAT on all purchases was temporarily reduced in 2008 by 2.5% until the end of 2009, which may also have brought forward some housing improvement expenditure from 2010.

The majority of dwellings are single-family houses. In England in 2000, 82% of households lived in houses, 16% in self-contained flats and 2% in bed-sits and other non- self-contained accommodation[4]. Over 90% of homeowners live in houses. The housing stock is relatively old in comparison to many other European countries – with 41% built before 1945 and only 13% since the mid-1980s.

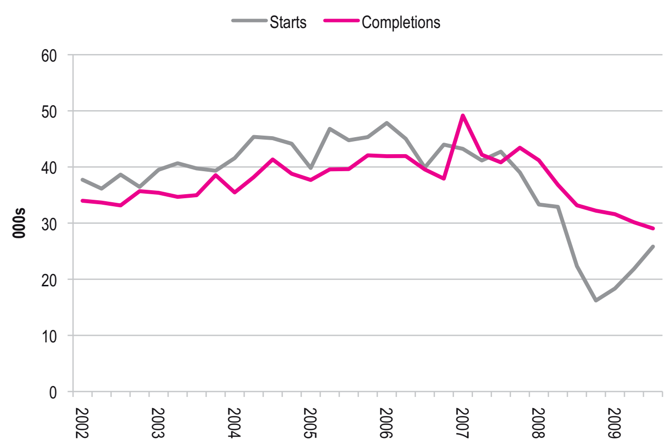

Figure 12.2: Housing starts and completions, 2002–2009

Source: CLG

[2]*England and Wales, CLG.*
[3]*CML based on mortgage transactions. Cash purchasers would have benefited as well.*
[4]*Survey of English Housing, DCLG.*

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Private renting

The UK now has probably the most liberalised private renting sector in Europe since the 1989 abolition for new tenancies of previous controls. There is only limited security of tenure for the first six months of a tenancy in the most common types of rental contract and rents are freely negotiable.

Around 8 million people live in the private rented sector. Demand has grown substantially in recent years, with the number of private tenancies rising by a third (1 million households) since the late 1990s. Younger and more mobile people in work are the main clients of the modern private rented sector. A quarter of private tenants are on lower incomes claiming housing benefit. They also tend to be far younger than the general age structure of the country's population. Once households become less mobile, they tend to move into owner occupation when they have saved enough for the down payment or, less commonly, into social housing.

The typical rental property is a terraced house in an outer or inner suburb of a town or city. The property will rarely be new: only 13% are post-1985, and almost two-thirds are pre-1945, although most will have been recently modernised.

Nowadays, three-quarters of landlords are private individuals and couples; about 10% are property companies and the rest a mix of other organisations[5]. There has been a substantial shift away from companies to individual landlords. The long housing boom saw many firms sell up or run down their property holdings, while the Buy-to-Let revolution encouraged many thousands of new investors to become landlords.

Buy-to-Let mortgages have grown rapidly over the decade of their existence. Over 1.2 million were outstanding by q3 2009, worth £144bn. Their expansion faltered after the middle of 2007 but was growing again by q3 2009[6].

Many small landlords have limited amounts of debt on their properties, despite the gearing and taxation advantages of doing so. Despite all the mortgage borrowing of recent years, the total amount of Buy-to-Let mortgage debt is actually worth only a quarter of the value of the private rented sector. Other forms of debt are unlikely to take the total amount of debt to much above 30% of total asset value[7].

Housing for rent is the UK's biggest property investment asset class. Its value rose rapidly in the recent long housing boom and with the expansion of Buy-to-Let, so that by 2006 it was worth over £500bn. In fact, the value of the private rented sector is now worth more than the sum of all of the privately-owned commercial property in the UK: offices, shops, hotels, factories, warehouses, leisure facilities - including both owner occupied and rented buildings[8].

There had been concern regarding high levels of Buy-to-Let defaults once the boom in house prices faded and the consequent impact on the overall market. Yet, despite the scale of the UK housing market crash, the number of Buy-to-Let mortgages with more than 1.5% of the balance in arrears remains low at 1.7% of outstanding Buy-to-Let mortgages in q3 2009; and repossessions were at only 0.14%[9]. In fact, all measures of Buy-to-Let borrower delinquency fell throughout 2009. This situation was aided by low interest rates but it suggests that Buy-to-Let is not the market destabilising threat once feared by some commentators. Despite this, Buy-to-Let mortgages tend to be classified by lenders as relatively high risk (and by those that finance mortgage lenders), so that loan conditions remain tight. This is particularly the case because specialist lenders had provided the majority of Buy-to-Let loans during the boom years but most of them have withdrawn from the UK mortgage market and the remaining ones experience difficulty in raising funds.

Some tenants are attracted to renting by the ease of moving and the low moving costs. Others are more sensitive to the relative costs of owning and renting. House price expectations influence tenure choice. Periods when rising prices are expected encourage households to enter owner occupation and the opposite occurs when prices are expected to stagnate or fall. Demand cycles for owning and renting consequently tend to vary over time. Currently, more people are renting because of expectations of continuing falling prices as well as because of greater problems in finding mortgages and raising deposits.

More flexible labour markets and a surge of foreign workers pushed up renting in London and elsewhere. Rent increases in the private rented sector have fluctuated in recent years, depending on the balance of demand and supply. Market rent levels tend to percolate through to existing tenancies quite quickly, although existing rents are likely to be sticky in a downwards direction.

Rents tend to weaken in a sharp recession like the current one and landlords are likely to face greater problems with rent arrears, because tenants are more likely to lose their jobs. RICS Residential Lettings Survey suggests that rents may start to rise again in 2010 after a year when they had been flat or falling. The demand for rental properties has been rising while supply is tightening. Many would-be sellers had been turning to the lettings market when their homes failed to find buyers, but the pickup in the sales market has diminished this practice. For most of the 2000s rental growth had significantly outpaced inflation until the onset of the crisis in 2007, according to DCLG data. Unfortunately, no authoritative index of rents currently exists. Rents are likely to rise over the long-term for the same reason as house prices, because of a growing shortage of residential accommodation in relation to demand.

[5] *English House Condition Survey 2006 Private Landlords Survey, DCLG.*
[6] *CML.*
[7] *M. Ball The UK Housing Market. Origins and Prospects. National Association of Estate Agents, 2008.*
[8] *2006 figures, own estimates based on Office for National Statistics data.*
[9] *CML.*

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Landlords' yields from rental income are not particularly high. During the boom years, house price rises eroded uplifts in rental income, while in the recession rents may have softened more than capital values. The yields recorded by ARLA have hovered around 5% for some years, including q3 2009, and IPD's income return for large-scale investors is only 3% and again fairly stable. Each is measured on different bases but overall they suggest that pure rental returns are low. However, overall yields were greatly enhanced by rises in capital values during the house price boom, which encouraged many investors to enter the sector. Prices are currently falling but many investors continue to expect house prices to rise over the long-term and so have little incentive to sell.

Social housing

Social housing is divided between local authorities and registered social landlords (RSLs), non-profit housing associations and trusts. By the early 1980s, the UK had almost a third of its housing stock in the social sector – one of the highest shares in Europe. Sharply reduced new building rates and sales of existing dwellings have substantially lowered social housing's role since then. Council housing's tenure share has declined by almost two-thirds from its peak level but the growth of RSLs, partly through acquiring ex-council housing, has meant that social housing overall still accounts for 18% of the total housing stock - one of the highest shares in Europe.

Discounted sales to sitting tenants and others have been substantial. Almost 2 million social dwellings have been sold to the private sector since the early 1980s, mainly to sitting tenants at a heavy discount to market value. Numbers recently peaked at almost 70,000 in 2003 but have declined since and they have been very low since the onset of the housing market crisis.

Social housing is now increasingly the home for lower income groups outside or on the margins of the labour market and recent immigrants, as in several other EU countries. Part of the private rental sector also plays a similar role by accommodating households whose rent is fully or partly paid through means-tested housing benefit.

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Housebuilding

By international standards, UK per capita housebuilding rates are low, reflecting the degree of planning constraint that exists. Between 1996 and 2002 housebuilding actually fell, despite the rapid rise in house prices over the period (Figure 12.3). Housebuilding rates did improve in the later years of the boom, with starts a fifth higher in its last three years than they had been around the turn of the century. Output has plummeted in the recession, as noted earlier, and now is about half the pre-crash level, though gradually improving.

A series of schemes have been introduced by the Government over the past two years to sustain housebuilding. They are mostly associated with higher levels of social housing and have had the effect of stopping even greater declines in construction.

An indirect effect of government support for the banks was that it helped the largest housebuilders to restructure their huge debts rather than go under and they were also able to start rebuilding their balance sheets with new private market capital injections during 2009. Many smaller builders have been less fortunate and construction unemployment has rocketed. The huge loss of capacity may hinder revival.

Much of the increase in building after 2000 was due to higher housebuilding densities, because the amount of land used for housebuilding actually fell by a quarter. Brownfield acreages were static on a trend basis but there has been a precipitous fall in the amount of greenfield land used, with the area used declining by a half between 1994 and 2005. Building densities rose and an increasingly large share of flats rather than houses was built during the boom. Outside of London, new apartment markets have been the worst affected by the housing market downturn.

The poor supply record exists despite the fact that the country has ostensibly one of the most market-oriented housing systems in Europe with a high share of owner occupation, a decontrolled private rental sector and a highly competitive mortgage market. However, such a market perspective does not extend to the key input of land, which is strongly regulated by planning and other state controls over greenfield development, building densities and urban regeneration.

Government has set a target of 240,000 new dwellings to be built in England annually until 2020. Current production is running at less than half of that. Rising living standards and the substantial increase in household numbers expected over the next decade or so highlight the enormous supply side shortage that exists and will continue to grow. There seems little prospect of loosening planning constraints by much. The trend of housing output over the past twenty years in England has been stationary at around 150,000 dwellings per annum. So, the long-term outlook is one of severe housing shortages and escalating house prices.

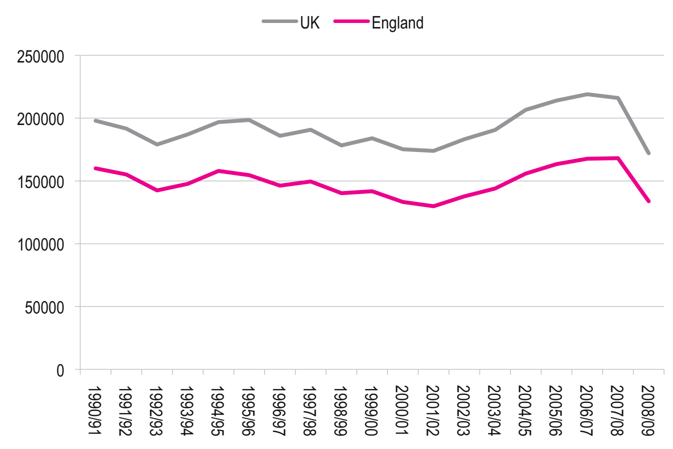

Figure 12.3: Housing completions, 1990/91–2008/09

Source: DCLG

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Macroeconomic influences

The economy moved into recession in the second half of 2008. The speed of the economic slowdown was rapid and the impact widely felt throughout the economy. GDP in 2009 fell by around 4.5%. Recovery is expected in 2010 with about 1.2% growth[10].

Inflation was beginning to rise at the end of 2007 and peaked at over 5% in the autumn of 2008. This encouraged the Bank of England to be cautious in its interest rate policy in face of the mounting problems of economic decline but eventually it started to cut rates aggressively in the autumn and rates have stayed low since then. Inflation is now below the 2% target and, after a tax adjusting blip early in 2010, is likely to remain there for some time, given the likely weak recovery and high level of unemployed resources.

Mortgage market influences

The decline in mortgage lending following the start of the credit crunch in 2007 was dramatic and unprecedented. The number of mortgage advances for house purchase dropped from around 60,000 a month in summer 2007 to only 18,000 in November 2008. Since that trough they have recovered quite substantially; rising to 42,000 in October 2009, according to the British Bankers Association. The recovery has entirely been in lending for house purchase rather than remortgaging, which has continued to decline (Figure 12.4).

The mortgage debt to GDP ratio stood at 86% in 2008, according to the European Mortgage Federation. This was the third highest in the EU, after Denmark and the Netherlands (and Iceland and Switzerland outside of the EU). Expressed as a share of disposable income, the amount of mortgage debt has risen from around 85% of income at the turn of the century to a substantial 137% in 2008, the highest ratio amongst the world's leading economies[11]. Households have also been deleveraging since the onset of the financial crisis. This can be seen in the mortgage market where substantial aggregate equity withdrawal up to 2008 has since turned into significant mortgage debt repayment (Figure 12.5). The level of UK consumer indebtedness acts as a brake on future housing market expansion and could present a risk to recovery if external events, such as a run on sterling, forced sudden increases in interest rates.

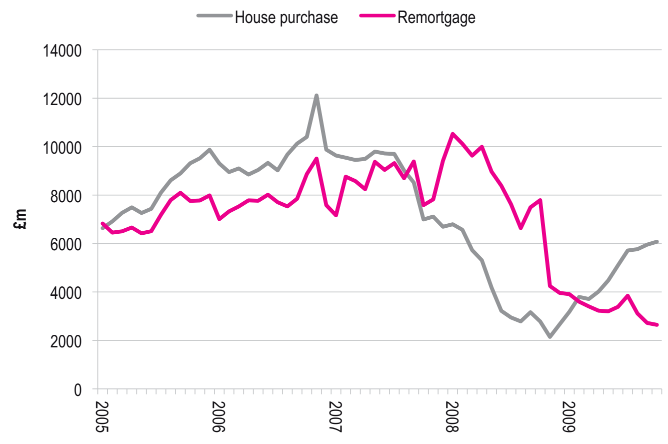

Figure 12.4: Mortgage loans for purchase and remortgage, 2005–2009

Source: CML

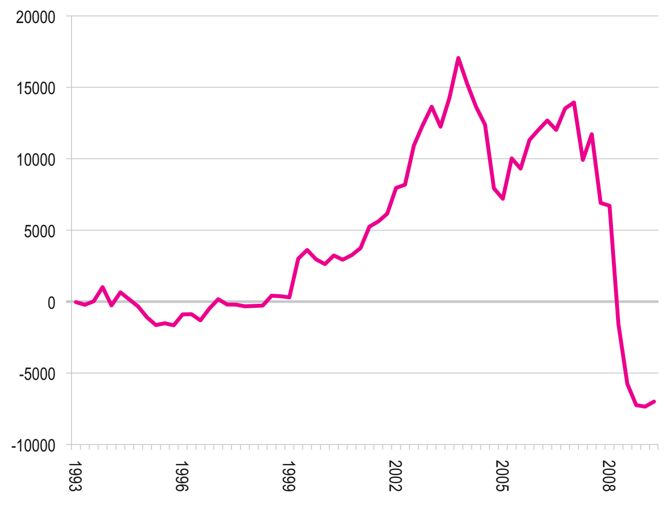

Figure 12.5: Equity withdrawal, 1993–2009

Source: Bank of England

[10] *UK Treasury*
[11] *OECD*

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Mortgages are traditionally of the variable rate type. Under British practice, lenders' standard mortgage terms enable them to alter interest rates at any time with no caps on the rate changes. A wide variety of new mortgage products were introduced during the boom years but then the majority of them were withdrawn as the financial crisis intensified. One of the main constraints has been related to loan-to-value (LTV) ratios, with 75% maxima typically imposed at the height of the crisis. However, higher LTVs became feasible again in 2009, though significant mark-ups were charged in terms of set up fees and interest rates. There has been a marked increase in the use of 'fixed' interest rate mortgages, although these typically differ from the long-term contracts used in many other countries. Generally, the interest rate is only fixed for a few years, after which the mortgage reverts to the lending institution's prevailing variable rate for the remainder of the loan period. Fixed rate mortgages accounted for three-quarters of lending in the last few months of 2009, partly because of expectations of rising interest rates but also because often they were the only product on offer to specific applicants in the new highly rationed mortgage market.

Approvals still remain weaker than before the crisis because of the loss of a large number of lenders as well as because of the tighter lending criteria of those remaining. The credit crunch so dramatically affected the UK mortgage market because lenders had increasingly come to rely on capital markets for funding. Between 2000 and 2007, the top ten mortgage lenders' reliance on customer deposit funding for net lending declined from 72% to 55%[12]. The securitised financing route also enabled specialist lenders to build up substantial market shares. Consequently, the closure of the market for residential mortgage backed securities (RMBS) badly affected the UK's mortgage market. Though there have been some security issues in 2009, capital markets currently provide little funding for mortgage lending. Towards the end of 2009, the Bank of England highlighted the need for substantial changes in the ways UK banks issue RMBS before they are likely to win extensive private capital market interest again. Overall, there is little likelihood of much expansion in the supply of mortgage finance in 2010, which will act as a major constraint on market activity.

Demographic influences

Demographic projections for the UK have been sharply revised upwards recently, highlighting that pressure on the housing market from demographic factors will continue for many years to come in contrast to some other EU countries, like Germany and Italy. The population as a whole of 60.5 million is expected to increase by 4.4 million by 2016 and to reach 71 million by 2031, if past trends continue[13].

Recent government household projections suggest that there will be a further 6.3 million households by 2031 (29% more than in 2006) – an annual growth rate of over 252,000. The majority of them will be one person households in older age groups. By 2031, a third of households will be headed by someone aged 65 or older, up from 26% in 2006.

Along with these increases, the dependency ratio (people 65 and above as a percentage of those of working age) will rise from 25% in 2010 to 38%. The increase in the share of the elderly is not as fast as in some other European countries but will still have a significant influence on future housing demand. Most of the growth in single person households, for example, will take place amongst those aged 50 or more.

Immigration has risen in recent years with approximately 500-600,000 people annually settling in the country between 2004 and 2008. Emigration has also been high, so the net contribution of migration has been of the order of 200,000 a year, though it has dropped since 2008 as emigrants have risen and immigrants fallen as the economy has contracted[14].

Immigration puts particular pressure on the areas of greatest housing shortage because migrants move into the most economically dynamic areas, whereas emigrants are more likely to come from across the country. Immigrants have a disproportionate effect on demand in the private rented sector rather than on homeownership, at least in their initial years in the country.

[12] *CML & Crosby, Mortgage finance interim analysis, HM Treasury, London, 2008.*
[13] *Office for National Statistics.*
[14] *Office for National Statistics.*

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Factfile: United Kingdom

Population (m) 2008	Annual population Growth %	Fertility rate* 2007	Years life expectancy 2007
61.2	0.7	1.8	78

Background

** Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)*

	2005	2006	2007	2008	2009f
GDP per capita purchasing parity standard based (EU27=100)	122	121	119	117	-
Real GDP growth %	2.2	3.1	2.7	0.6	-3.5
Growth in real private consumption %	2.2	1.5	2.1	1.2	-3.0
Inflation – consumer prices % (HICP)	2.0	2.3	2.3	3.6	2.1
Labour participation rate % (15–65 yrs old in work)	-	-	76	77	77
Employment growth	-	-	0.7	0.8	-2.1
Unemployment rate %	4.8	5.4	5.4	5.7	8.0

Economic

	2005	2006	2007	2008	2009f
Growth in residential investment	-4.4	9.9	0.9	-22.7	-27.8

Housing market

- Owner occupied housing: Mortgage interest relief – no
- Capital gains exempt – yes
- Imputed rental income – not taxed
- Property taxes as share of all taxes 2002: 12%
- Property taxes as share of GDP 2002: 4%

Taxes

Sources: ONS, Eurostat, OECD.

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